GROWTH, VOLATILITY AND FINANCING IN LATIN AMERICA AND THE CARIBBEAN

José Luis Machinea
Executive Secretary of ECLAC
Geneva, 21 February 2005
DURING THE LAST 15 YEARS, LATIN AMERICA HAS

- Implemented structural reforms
DURING THE 1980s AND 1990s, LATIN AMERICA HAS IMPLEMENTED STRUCTURAL REFORMS
TARIFFS WERE SIGNIFICANTLY REDUCED

Average tariff MFN

> 100%
29%
10%

Weighted by preferential trade agreements the average regional tariff was reduced to 5%
AND TRADE OPENNESS COEFFICIENTS INCREASED
DURING THE LAST 15 YEARS, LATIN AMERICA HAS

- Implemented structural reforms
- Experienced faster export growth
EXPORT VOLUMES GREW AT AN ANNUAL RATE OF 9.1% DURING 1990-2003

Growth of export volumes (annualized rate)
(Export value deflated by export price index, 2000 =100)
DURING THE LAST 15 YEARS, LATIN AMERICA HAS

- Implemented structural reforms
- Experienced faster export growth
- Received increased FDI inflows
FOREIGN DIRECT INVESTMENT

Latin America and the Caribbean’s (excluding tax havens)
Share of FDI going to Developing Countries %

- LAC as % of Developing Countries
- LAC as % of Developing Countries (excluding China)
## FOREIGN DIRECT INVESTMENT

<table>
<thead>
<tr>
<th>FDI/GDP</th>
<th>1996-2000</th>
<th>2001-2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ecuador</td>
<td>3.21</td>
<td>5.67</td>
</tr>
<tr>
<td>Chile</td>
<td>6.80</td>
<td>3.95</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.97</td>
<td>3.54</td>
</tr>
<tr>
<td>Peru</td>
<td>3.48</td>
<td>2.36</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.49</td>
<td>2.20</td>
</tr>
<tr>
<td>Colombia</td>
<td>3.19</td>
<td>2.13</td>
</tr>
<tr>
<td>Argentina</td>
<td>4.28</td>
<td>0.60</td>
</tr>
<tr>
<td>Central America and the Caribbean</td>
<td>3.97</td>
<td>2.96</td>
</tr>
<tr>
<td><strong>LAC</strong></td>
<td><strong>3.71</strong></td>
<td><strong>2.50</strong></td>
</tr>
</tbody>
</table>
FOREIGN DIRECT INVESTMENT

FDI as % of GDP

Chile
Nicaragua
Ecuador
Panama
Honduras
Costa Rica
El Salvador
Mexico
Central America & Caribbean
Dominican R.
Latin America & Caribbean
Mexico & South America
Brazil
Colombia
Peru
Bolivia
Uruguay
Venezuela
Paraguay
Argentina
Guatemala
Haiti

1990
1995
2004
DURING THE LAST 15 YEARS, LATIN AMERICA HAS

- Implemented structural reforms
- Experienced faster export growth
- Received increased FDI inflows
- Enhanced macroeconomic management
INFLATION HAS BEEN CURBED

Simple Average
1993: 883.7
1994: 331.2
DURING THE LAST 15 YEARS, LATIN AMERICA HAS

- Implemented structural reforms
- Experienced faster export growth
- Received increased FDI inflows
- Enhanced macroeconomic management
- Improved its access to private financial markets
NONETHELESS, OVERALL ECONOMIC PERFORMANCE HAS BEEN WEAK

- Economic growth has been low and volatile
REGIONAL GROWTH LOST MOMENTUM

Annual growth rates, 1959-2003
(10 year moving average)

Latin America
Industrialized countries
Developing countries, Asian
REGIONAL GROWTH BECAME MORE VOLATILE
Growth volatility, 1959-2003
(10 year moving average)

- Latin America
- Industrialized countries
- Developing countries, Asian
HIGH VOLATILITY IS MAINLY EXPLAINED BY EXTERNAL SHOCKS

- Financial flows volatility has replaced variability of terms of trade as the main source of external volatility
- Volatility has been mainly the consequence of highly volatile private financial flows (other than FDI)
GROWTH HAS BEEN CLOSELY CORRELATED WITH FINANCIAL FLOWS, BUT IN 2004 ...

Note: with respect to the output of \((t-1)\)
CAPITAL FLOWS HAVE BEEN VOLATILE AND FDI INCREASED
FDI HAS BEEN THE MOST STABLE COMPONENT OF EXTERNAL FINANCING

<table>
<thead>
<tr>
<th>Sources of external financing</th>
<th>CV</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>0.98</td>
</tr>
<tr>
<td>Exceptional financing</td>
<td>1.31</td>
</tr>
<tr>
<td>Capital account</td>
<td>1.70</td>
</tr>
<tr>
<td>Portfolio investment (debt)</td>
<td>2.29</td>
</tr>
<tr>
<td>Portfolio investment (equity)</td>
<td>3.20</td>
</tr>
<tr>
<td>Use of IMF credit</td>
<td>3.36</td>
</tr>
<tr>
<td>Other investment</td>
<td>7.21</td>
</tr>
</tbody>
</table>
HIGH VOLATILITY IS MAINLY EXPLAINED BY EXTERNAL SHOCKS

- Financial flows volatility has replaced variability of terms of trade as the main source of external volatility.
- Volatility has been mainly the consequence of highly volatile private financial flows (other than FDI).
- Official financing has been countercyclical.
SOURCES OF FINANCING CHANGED. OFFICIAL FINANCING HAS BEEN COUNTERCYCLICAL

Sources of External Financing
(As a % of total external financing)
HIGH VOLATILITY IS MAINLY EXPLAINED BY EXTERNAL SHOCKS

- Financial flows volatility has replaced variability of terms of trade as the main source of external volatility
- Volatility has been mainly the consequence of highly volatile private financial flows (other than FDI)
- Official financing has been countercyclical
- Local currencies have tended to appreciate as a result of capital inflows
STRONG TENDENCY TOWARDS CURRENCY APPRECIATION - CHANGES IN EXCHANGE RATE REGIME WHEN REVERSAL OF FLOWS OR SUDDEN STOPS OCURRED

Real Effective Exchange Rate Index

(Simple Average 1992-2002=100)

- Latin America
- South America
- Mexico and Central America
VOLATILITY OF REAL EXCHANGE RATE, 1992-2004

Real exchange rate volatility
(Coefficient of variation)

Mexico, Central America and Caribbean

South America

Latin America and Caribbean

Enero 1992-Diciembre 1998
Enero 1999-Mayo 2004
2002
2003
VOLATILITY OF TERMS OF TRADE, 1971-2000 AS % OF EXPORTS

% of annual variations greater than 20% of exports

Andean Community
CACM
MERCOSUR
ASEAN
VOLATILITY OF FINANCIAL FLOWS, 1971-1999, AS % OF EXPORTS

% of annual variations greater than 20% of exports

- MERCOSUR
- Andean Community
- CACM
- ASEAN
- EU
HIGH VOLATILITY IS MAINLY EXPLAINED BY EXTERNAL SHOCKS

- Financial flows volatility has replaced variability of terms of trade as the main source of external volatility.
- Volatility has been mainly the consequence of highly volatile private financial flows (others than FDI).
- Official financing has been countercyclical.
- Local currencies have tended to appreciate as a result of capital inflows.
- Very low domestic saving rate.
NATIONAL SAVING RATES HAVE REMAINED LOW COMPARED TO OTHER REGIONS
EXTERNAL SAVING HAS BECOME QUITE IMPORTANT IN FINANCING GROSS INVESTMENT
MACROECONOMIC IMPACT OF FINANCIAL FLOWS VOLATILITY DEPENDS ON

- Feasibility of countercycliclical macroeconomic policies
- Degree of trade openness
- Exchange-rate regime
- Weakness of regional and global financial architecture to provide public goods (liquidity)
- Financial system development and level of financial dollarization
MACROECONOMIC IMPACT OF FINANCIAL FLOWS VOLATILITY DEPENDS ON

- Feasibility of countercyclical macroeconomic policies
COUNTERCYCLICAL FISCAL POLICY

Restrictive fiscal policy pro-cyclical

Expansionary fiscal policy counter-cyclical

y = -0.2721x - 0.1029
R² = 0.2133
MACROECONOMIC IMPACT OF FINANCIAL FLOWS VOLATILITY DEPENDS ON

- Feasibility of countercyclical macroeconomic policies
- Degree of trade openness
ADJUSTMENT TO FINANCIAL SHOCKS DEPEND ON THE DEGREE OF TRADE OPENNESS

- Current account deficit is the counterpart of financial flows
- The output adjustment required to a change in capital inflow depends on the import and export ratio in the short run (in the long run elasticities have to be considered)
MACROECONOMIC IMPACT OF FINANCIAL FLOWS VOLATILITY DEPENDS ON

- Feasibility of countercyclical macroeconomic policies
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ONLY THE FAR – FLAR PROVIDED LIQUIDITY TO ITS MEMBERS
MACROECONOMIC IMPACT OF FINANCIAL FLOWS VOLATILITY DEPENDS ON

- Feasibility of countercyclical macroeconomic policies
- Degree of trade openness
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- Financial system development and level of financial dollarization
FINANCIAL DEEPENING CONTINUES TO BE BELOW INTERNATIONAL LEVELS

M2 as % of GDP
FOREIGN CURRENCY DEPOSITS AS PERCENTAGE OF TOTAL DEPOSITS

- El Salvador: 100%
- Ecuador: 100%
- Bolivia: 91%
- Uruguay: 85%
- Nicaragua: 82%
- Argentina: 74%
- Anguilla: 73%
- Paraguay: 67%
- Peru: 66%
- Costa Rica: 66%
- LAC: 58%
- Haiti: 43%
- Honduras: 43%
- Jamaica: 37%
- St. Kitts and Nevis: 37%
- Chile: 23%
- Guatemala: 20%
- Grenada: 11%
- Monserrat: 5%
- Dominica: 4%
- St. V. Grenadines: 3%
- St. Lucia: 3%
- St. Vincent: 2%
- Venezuela: 0%
CAUSES AND CONSEQUENCES OF FINANCIAL DOLLARIZATION

- Long history of inflation and large currency depreciations resulted in
  - Lack of long term saving and loans in local currency
  - Lack of financial deepening

- Dollarization of balance sheets affects governments’ and private companies’ solvency and consequently, the financial institutions related to them.

- Indexation seems to be a better option for the creation of long term financial markets
ADOPTING THE CURRENCY OF A DEVELOPED COUNTRY (DOLLAR, EURO)

A. Increase the convergence of interest rate
B. Reduces flexibility in dealing with external shocks

Lack of flexibility is a more significant factor when:

1. The local economy is not synchronized with the relevant developed country’s business cycle
   Particularly when:
   - Lack of synchronization in respect of external shocks:
     » Terms of Trade
     » Financial
   - Magnitude of external shocks
2. Less labor mobility
3. Lack of fiscal transfers
BUT FINANCIAL CRISIS ARE NOT SOLELY A CONSEQUENCE OF MACROECONOMIC CRISIS

Factors in the financial crises: shortcomings in bank regulation and supervision

1. Lax entry conditions into the banking industry
2. Inadequate handling of credit and foreign-exchange risks
3. Overstepping limits of related-party credit
4. Granting “false” credit and “evergreening” loans
5. Insufficient provisioning to cover hidden losses in credit and foreign-exchange risks
6. Lack of transparency in terms of risk and the effective capital position of banks
7. Dollarized bank assets not properly backed by ‘provisions’
AFTER MORE THAN A DECADE AND A HALF OF REFORMS, LATIN AMERICAN COUNTRIES’ DOMESTIC FINANCIAL SYSTEMS ARE STILL CHARACTERIZED BY:

- Preponderance of bank-credit, mainly short-term oriented
- Credit rationing, particularly for SME and innovative companies
- High and differentiated financial costs
- Scarcity of risk management instruments, particularly long-term ones
NATIONAL STRATEGIES TO SMOOTH OUT THE CYCLE AND INCREASE INVESTMENT

- Countercyclical macro policies
  1. Fiscal Policy
     - STRUCTURAL FISCAL DEFICIT
     - STABILIZATION FUNDS
  2. Countercyclical monetary policy
     1. Reserve requirements
     2. Loan provisions

- Global, regional and sub-regional financial arrangements

- Managed flexibility of exchange rate

- Regulation and supervision in order to avoid:
  1. Currency and maturity mismatches (avoid incentives for dollarization)
  2. Excess indebtedness
NATIONAL STRATEGIES TO SMOOTH OUT THE CYCLE AND INCREASE INVESTMENT

- Pro-Investment policies
  1. Raise domestic saving (public and private)
  2. A lower tax rate for firms than for individuals (on a temporary basis)
  3. Financial deepening and development of capital markets
  4. Existence of institutional savings
  5. Bias towards small and medium-sized firms
PENDING REFORMS

- Increase financial deepening
- Diversify sources of financing (financing is provided mainly by banks)
- Increase access to credit for SME (domestic capital markets are only accessible to large firms)
- Adoption of financial supervision standards together with an anti-dollarization bias
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