FINANCING ECONOMIC GROWTH IN A CHANGING LANDSCAPE
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To the Atlanta Fed/National Association of Business Economists Conference on Financing Trade and Investment in Latin America
Miami, Florida
February 19, 1993

I am delighted to be here today to discuss the topic of financing growth in the emerging market economies of Latin America. As I have said on other occasions, the changes that have taken place in Latin America over the last few years are truly momentous in their historic significance. This significance is perhaps greatest for the people of these countries who stand at long last on the threshold of true economic growth and change that is the basis for economic development and higher living standards for all citizens. However, this time is also of great importance to those of us living in already industrialized economies because of the great opportunities for expanded markets at a time when our populations and our economies are growing slowly by past standards.

As I see it, we stand at a watershed vis-a-vis Latin America. The debt crisis is receding. Domestic policy reforms seem to be taking root. However, we have been here before, so to speak. Latin America has undergone several debt crises, three in the last 100 years. Moreover, Latin America has always offered tremendous potential for growth, yet it has not translated this potential into full membership in the community of advanced economies or high living standards for a very broad segment of society. This time it is my fervent hope that economic growth will be both lasting and wide-reaching in its effect, catalyzing not just growth but true economic development that transforms the Latin economies into fully industrialized economies and that creates prosperity for all members of society.

This morning's speakers have given you an excellent and detailed update on economic conditions in the major countries of Latin America and of the economic policies that underlie many of these changes. This afternoon you will be hearing, again in some detail, from several extremely well-qualified speakers about some of the financial innovations and techniques that are being developed to meet the credit needs of these growing economies. My task is to provide a broad scope to the issue of financing economic growth and development. As a central banker, naturally my primary perspective is that of a policymaker rather than an investor, business executive, or scholar. However, this perspective is relevant both to those who are just considering expanding into Latin markets as well as those who are actively seeking to expand or deepen their business involvement because business decisions are inevitably affected by the broader policy context.

So, today I would like to paint a broad brush view of some of the major changes in financing that are taking place in regard to Latin America and what factors underlie them. I shall also spend some time sharing what I see as the significance of these changes. Finally, I would like to leave you with some thoughts about future prospects and what other changes should take place.

Shifts in Financing--What and Why

Let me begin with the most obvious financial change, namely, the considerable reduction in the amount of troubled external debt since the onset of the debt crisis in August 1982. Commercial bank debt has been reduced by nearly $60 billion from 1986 to 1991, according to BIS figures, a decline of 23 percent. Some countries are completely out of arrears while most have established comprehensive programs for reduction of both debt and debt service. Of course, lower interest rates in the United States have facilitated this process since interest on many loans was calculated in dollar rates.

A related but separate development pertains to the secondary market for this debt which was established through the Brady plan. That development is twofold: these secondary markets have deepened, and the discount of market price from par is much less in many cases. For example, Mexican debt was trading at 33 cents on the dollar in 1989 and is now trading closer to 70 percent of par. Overall, debt reduction, combined with the macroeconomic stabilization policies and structural reforms you heard about this morning, has resulted in renewed access to capital markets, not just for those countries which are no longer in arrears but for certain others as well.

Not only has the level of financing increased but also the composition of financing has become more varied in several ways. Whereas in the 1970s and early 1980s by far the most common form of meeting credit needs was through commercial bank lending, such traditional loans are now in abeyance. This drop is largely the result of an understandable reluctance to extend traditional loans in Latin America after the problems of the past decade. Higher capital standards that banks are required to meet have tended to reinforce that reluctance. Banks are not out of the current picture, however. They play an important role in trade finance and indirectly in Brady plan type securitization.

While bank loans have diminished in volume, securities--both bonds and equity--are becoming increasingly common. Beyond this growth in equities and bonds, there is another financial development. While I do not profess to be an expert on the subject, I have noted that there is growing interest in derivative instruments especially in Mexico and Venezuela.

This growth in securities is fairly broad in terms of issuers. Privatization of government-owned industries has been accompanied by major issues of new securities. In addition, there are encouraging signs that private sector corporations, especially exporters, have been able to issue equity shares and commercial paper abroad. This is a notable change from the pre-debt crisis period when more credit was in the form of sovereign lending.

With this shift in the form of financing has come a shift in the composition of creditors. Along with commercial banks, which are involved through securitization and trade finance as I noted, we are seeing more investment banks and institutional investors. Likewise the national composition of creditors has broadened somewhat beyond the traditional countries of the United States and to a lesser extent Germany to other European countries and Canada. In addition, according to the Inter-American Development Bank, many nationals from the Latin American countries in the bond market have purchased a portion of the bond offerings, resulting in a recovery of flight capital. The growth of securitization has facilitated this broader involvement.

Aside from a higher volume and greater diversity of sources of funds, there has been a twofold increase in foreign direct investment from 1990 to 1992, according to World Bank figures. This growth is no doubt due to the more favorable financial and economic climate implied in all of the foregoing. A final development pertains to the time dimension of credit. The initial maturity of credit is being extended from the relatively short time horizon of much bank lending to the longer maturities of certain bonds and especially of stocks and direct investment.

I have already made indirect reference to many of the reasons for these changes. Macroeconomic policy reforms have succeeded in lowering inflation, rekindling growth, and increasing the creditworthiness of many countries. Market reforms such as tariff cuts, reductions in other barriers to trade and foreign investment, and privatization have been vital as well. The Brady Plan, and indeed its predecessor the Baker Plan, helped set out a structured way to reduce debt levels. (The Baker plan fell far short of its goal of raising new capital but, in my opinion, it helped prevent a total debacle and laid the groundwork for the Brady Plan by lending credibility to domestic reforms that were beginning to be considered.) Also, the decline in interest rates, especially in the United States, automatically lowered debt service burdens and made refinancing easier. At the same time with very sluggish economic conditions in many industrialized economies, rates of return have shifted in a way that is favorable to Latin America.

Assessment of These Changes in Financing Patterns

On the whole, I believe these changes I have enumerated are very positive.

Diversification has always been a sound financial precept, especially from the perspective of a policymaker, and financing has become more diversified--as to type (that is loans versus bonds versus equity), institutional sources, countries, and types of borrower (sovereign vs. private firms). The longer maturities of securities, especially equities, along with increased direct investment, suggest that there will be less of a risk that capital flows will be quickly reversed. Obviously this stability is important to domestic policymakers and business people in Latin America. It should also stem capital flight. It is also probable that there will be less risk of systemic weakness in global financial markets with less volatile capital flows. With longer term lending and more creditors being owners of securities, there is greater potential for a longer term investment strategy that enhances productivity and thus raises living standards.

However, there are some troubling dimensions to these changes also. First, let me stress these are incipient changes, not complete shifts. Insofar as capital inflows are a function of low interest rates and mediocre growth in the advanced economies, a reversal of capital flows could occur if these conditions change. Additionally, while I fully endorse the policy reforms that have been implemented throughout Latin America, I recognize that such a dramatic shift will entail short-run transition costs that in some societies may prove untenable. We saw evidence of this last year in Venezuela and Colombia. Leaders of these countries have a delicate balancing act to carry out at a time when traditional capital surplus countries like Germany and Japan are, for different reasons, cutting back on overseas lending and investment.

Finally, the fact that financing has increased does not mean that it has become adequate.

Considerable money is needed to continue the task of privatization that is really at the early stages in most of Latin America; the scope of this problem becomes clear when we consider that other countries will be competing for the world's scarce savings in the years ahead. Eastern Europe and the former Soviet Union have the same needs, which are not now as pressing due to the preliminary state of reforms there. Eventually, however, those countries are likely to be major borrowers in international capital markets. Moreover, China and perhaps India may seek to import sizeable amounts of capital in the decade ahead.

I would also like to see encouragement of even more growth in foreign direct investment, coupled with appropriate regulations to protect workers and the environment as well as a taxation system that treats businesses consistently. This form of investment tends to foster a long-term involvement in the local community when approached in this balanced manner. We have seen in the United States and especially in the Southeast how much foreign-owned plants can add to the employment base and contribute to the local community.

Policy Prescriptions

Where are we going from here, or perhaps I ought to say, where should we go from here? Some of my prescriptions are clear from the remarks I have just made. Macroeconomic stabilization policies must be maintained albeit with a sensitivity to transition costs. Microeconomic reforms must be continued and extended to ensure that capital, whether raised domestically or internationally, is used efficiently to develop internationally-competitive industries, not wasted on excessive consumption or showpiece projects.

Other prescriptions may be implicit in these, but since they have not been fully implemented I think it is worth emphasizing them. Access to capital needs to become available to a wider number of firms. In the United States, having a solid middle class and a strong corps of small businesses has been an essential ingredient in the flexibility of the U.S. economy as well as a factor in the stability of its political system. Very widespread private property ownership in the form of home ownership is also strongly encouraged by public policies. Of course, private property of both U.S. citizens and firms as well as foreigners is protected, including the financial assets. In turn, having such a stable political system has attracted investment and economic growth, and having a large prosperous middle class has made the American market much sought after because of the aggregate buying power of consumers.

Many Latin countries unfortunately remain divided societies and hence prone to the divisive forces of extreme political voices. Thus, as a policymaker I hope that more ways can be found to increase financing available to smaller firms in Latin America as a way of fostering societies that are less polarized economically. This economic change will enhance the progress that has been made toward democratic reforms although political leaders must continue to push very hard in this direction, in my opinion.

Finally, Latin American countries must continue to work to establish market economies. Doing so entails not only fostering the growth of financial markets along the lines I have outlined today but also regulatory restructuring. Misguided regulations like foreign investment barriers and government mandates that require banks to allocate credit to certain industries and sectors of the economy need to be abandoned. At the same time policymakers must do more to establish a regulatory framework that is appropriate for market economies. In the financial service industry, legal and institutional frameworks must be set up that will enable the information gathering and distribution function that is the core of financial intermediation to thrive.

I know that the Foreign Bank Supervision Enhancement Act has proven frustrating to those banks that have applications pending and may even seem arrogant to foreign countries that are, in effect, asked to reform their bank regulatory systems if they want their banks to do business in the United States. Nonetheless, I believe that such reforms are every bit as essential to sound economic progress as are the capital standards agreed to in the Basle Agreement in the late 1980s by the G-10 countries. More broadly, all countries aspiring to become fully industrialized must develop a system of property rights, laws, and regulations that creates a sense of trust among businesses, consumers, and financial intermediaries and in turn facilitates business transactions.

Conclusion

As you can tell, I am very excited and optimistic about the developments in Latin America. The changes in financing that are already under way are most encouraging, although we all have more work to do. Rather than summarizing or repeating what I have already said, let me leave you with a challenge. The 1980s are known as the Lost Decade for Latin America. It was a time when external financing declined as interest rates rose, causing many Latin American countries that were in debt to reduce their imports and to cut domestic investment.

These actions led to a decline in growth rates and per capita income. All in all, this past decade was not a good one for either those people living in Latin America or for those creditors that had helped finance growth earlier.

Now in the 1990s, these economies are rejuvenating themselves. In essence, Latin America has begun to find itself again--through strong leadership, stabilization polices, and privatization. In turn, investors in this country and from around the world have begun to find Latin America again--through increased trade, debt reduction, and financial innovations.

It is too early to say whether Latin America will finally be able to put the Lost Decade behind it for good and join the industrialized nations as a full partner. However, I believe this decade of the 1990s could indeed come to be known as the Making-Up-for-Lost-Time Decade. Such an accelerated turn of events will test the knowledge and insight of policymakers, financial intermediaries, and investors--in the advanced economies as well as in Latin America. Having come this far, I am very hopeful we will meet this great challenge.