

LATIN AMERICA'S ECONOMIC BOOM--THE U.S. PERSPECTIVE
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As a longtime observer and admirer of Latin America, I am delighted to speak with you today about the U.S. perspective on the potential for economic growth in Latin America. Eight years ago when I first started speaking about the possibility of a renaissance in economic growth in Latin America, I felt like the proverbial voice in the wilderness. Now I hear many voices joining with mine to speak about the stunning turnaround since the Lost Decade of the 1980s. Indeed, I believe the future has never been brighter for Latin America.

Today, however, I will focus not only on what has been accomplished to usher in economic growth but also on what needs to be accomplished to assure continued growth. From my point of view as a central banker, the key to continued long-term, stable growth in Latin America--in addition to the macroeconomic policies that have already been put in place--depends on each country having a sound payments system and a strong financial structure. Both of these prerequisites to continued growth absolutely require an independent central bank or some entity that serves the same purpose. Independent monetary policy is essential.

Why are such structures so critical to the future of Latin America? History has taught us that financial intermediation is a kind of keystone in any advanced economy. And, as we have seen recently in Eastern Europe, true and lasting market reform is difficult to achieve when

restructuring the banking system lags behind other reforms. But even more to the point for those many countries in Latin America that have suffered bouts with hyperinflation, a strong and independent central bank would take steps to reduce and contain inflation. The most immediate benefit of an independent central bank would be relief from hyperinflation for the simple reason that the government could no longer print money to pay its debts. Having a central bank that is independent from the government, that handles monetary policy, that oversees the payments system, and that, at least to some degree, supervises the banking industry is the only sure way I know of to create an environment in which an economy can stabilize and flourish.

The decisions by various Latin American countries to transform their protected economies into market economies has been the significant first step in the process of ensuring long-term, sustainable growth. By turning toward market economies, Latin American countries have attracted diversified external financing and have experienced an upturn in economic growth. In the meantime, though, there is much work to be done to become a full member in the community of advanced economies. Countries that do not have sound banking systems in place have never been able to sit at the same table with those who do. But before I discuss the importance of a sound financial structure in more depth, I would like to give some background on the economic and financial environment in Latin America.

The Economic Environment of Latin America

As a region, Latin America continues to enjoy a meaningful economic recovery from a long period when stagnation, accelerating inflation or hyperinflation, and debt crises plagued

various countries. The Organization for Economic Cooperation and Development (OECD) forecasts a 3.5 percent rise in the gross domestic product for the region as a whole in 1994, down slightly from 4 percent last year. The range runs from a contraction of GDP of about 3 percent in Venezuela to expansion of more than 4 percent in Argentina and Chile and more than 6 percent in Peru.

Much of this growth is being sustained by reforming macroeconomic policies and by introducing market-oriented structural reforms. Deficit reduction, more credible monetary policies, and privatization of state-run enterprises have been successfully implemented in many countries of the region. Inflation has been slowing in most of the major countries, and the introduction of a new currency in Brazil has, at least for the moment, brought inflation down from more than 40 percent *per month* to less than 10 percent a month.

However, economic stabilization measures have not been implemented without pain, as we have seen in Venezuela. Moreover, Mexico has been struggling through a difficult election year. Let me address these setbacks in a bit more depth. Mexico has a history of election-year turmoil, going back to 1976 with the devaluation of the peso and to 1982 with the beginning of the debt crisis and the sudden nationalization of the banks. This year, the revolt in Chiapas and the assassination of a presidential candidate created a good deal of nervousness. To compound the situation, the peso came under pressure, interest rates rose, and economic activity slowed. Prospects have improved over the past month, however, in part because the president-elect of Mexico has pledged to continue economic and political reform. In addition, the country has

come a long way in terms of privatizing its government-run businesses. Given my thesis about the form of central banking that is critically important for long-term growth, I am also most pleased that Mexico has moved toward creating an independent central bank. In addition, over time, the North American Free Trade Agreement (NAFTA) should lead to many new business opportunities and improved growth. Therefore, in spite of recent turmoil that has caused hardship in Mexico, I believe that the fundamentals look good and that the outlook remains promising for the long term.

The situation in Venezuela, with the turn back toward a state-controlled economy, is more clearly a major setback for that country, and, to some extent, for the region as a whole. The collapse at the beginning of the year of Banco Latino, the second-largest bank in that country, has been followed by the government rescue of a number of other banks. This de facto nationalization of the banking system in Venezuela has initially cost the equivalent of about 10 percent of GDP. Ironically, and sadly, new banking laws went into effect in Venezuela only two weeks before Banco Latino failed. Now, with price and exchange controls in place, the bolivar has depreciated at a steep rate against the dollar, and inflation is rising rapidly. The swift turnaround in the fortunes of Venezuela serves as a reminder that market reforms do not take hold overnight. However, since Latin America is so diverse and many countries are rather autonomous economically, setbacks do not automatically spread from one country to another. In fact, I would like to hope that this example of a country faltering may reinforce for other countries how important it is to stay with a course of reforms.

In sum, we have witnessed many steps forward to more stable economies in Latin America, especially in Argentina, Chile, and Mexico. A few large steps backward have also been taken, most notably in Venezuela. It is important to remember, however, that overall momentum from the reforms is propelling Latin America onto an equal footing with other nations that have developed economies.

The Financial Environment in Latin America

Let me turn now to what Latin America has achieved in terms of financing its economic growth. Importantly, these monetary, fiscal, and structural policy reforms have increasingly succeeded in bringing flight capital back to the home countries and in persuading American, European, and Japanese investors to make new investments in the region. The Bank for International Settlements (BIS) estimates that inflows of portfolio capital into the region tripled from around \$22 billion in 1991 to about \$68 billion in 1993. In Chile, this financial turnaround has been aided by the creation of private pension funds, which will serve as a major source of investment capital. Privatization of government-owned enterprises has opened up new opportunities for foreign as well as local investors. On another encouraging note, other Latin American countries are beginning to emulate Chile. In addition, the stock markets in various countries are much more vibrant than they have been in past years.

Financial reforms in Latin America have followed 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. According to World Bank figures, commercial bank debt has been

reduced by nearly \$100 billion from 1986 to 1992, a decline of almost half. Some countries are completely out of arrears, while most have established comprehensive programs for reduction of both debt and debt service. Furthermore, Latin American governments have issued much of the renegotiated debt as equity, thereby providing some room to maneuver when servicing claims.

Both the level and composition of financing have become more varied. Whereas in the 1970s and early 1980s by far the most common form of meeting credit needs was through foreign commercial bank lending, such lending has decreased in importance. This drop is largely the result of some unwillingness on the part of foreign banks to extend traditional loans in Latin America after the problems of the past decade. In addition, higher capital standards that banks are required to meet have also understandably increased this reluctance.

Although bank loans have diminished in volume, securities--both debt and equity--are becoming more common. This growth in securities is fairly broad in terms of issuers. Major issues of new securities have followed from the privatization of government-owned industries. In addition, there are encouraging signs that private-sector corporations, especially exporters, have been able to issue equity shares and commercial paper abroad. 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, underwriting, and trade finance, we are seeing more investment banks and institutional investors.

Again, a major reason for this healthier financial outlook is macroeconomic policy reforms that have succeeded in lowering inflation, rekindling growth, and increasing the creditworthiness of many countries. Structural market reforms such as tariff cuts, reductions in other barriers to trade and foreign investment, and privatization have been vital as well. Also, the decline in interest rates, especially in the United States until recently, has lowered debt service burdens and made refinancing easier.

Reforms Necessary for Continued Growth

Notwithstanding these very favorable developments, some significant hurdles remain. Among the evolving economic and political reforms taking place in many countries, one area that has not yet become firmly implanted is private property and contract law. In many countries, such laws are taken for granted. However, in countries where nationalization has been a recurring theme, the concept of private property exists on shaky grounds. Setting up an enduring legal system as a foundation for newly privatized companies and property is a daunting challenge, but one that must be met. Otherwise, private and corporate citizens will continue to operate as though the government could take their property at a moment's notice. It is in fact this very real fear of enforced nationalization that caused the extremely complex pattern of offshore holdings that developed in many Latin American countries. With the upheaval in Venezuela, I fear we may see a recurrence of this behavior in that country.

Private property laws are fundamental to reform, but today I would like to speak more about the other large hurdle that must be cleared: the establishment of an independent central

banking authority and a sound financial structure. In a world that is driven more and more by technology linking countries more closely, unsound banking practices pose threats to more than the home country. The failure of Banco Latino and its affiliates in the United States and Curaçao did not affect the U.S. system. Yet it did raise serious concerns about the possibility of problems arising when proper supervisory and regulatory controls are not in place. The collapse of BCCI is another cogent example of unsafe banking practices that have the potential to disrupt global banking. Generally speaking, such controls are enforced by strong, independent central banks. In order to assure the security of the international banking system, it is important that all countries have an independent supervisory authority and that all financial institutions be subjected to comprehensive and consolidated examinations.

Besides appropriate supervision, another important part of any financial structure is the payments system. For instance, financial markets in every country depend on a reliable payments system to ensure their liquidity and efficiency. Central banks generally oversee the payments system thanks to their having account relationships with commercial banking organizations and to their supervisory role with these same banks. During the course of its supervision of the commercial banks under its aegis, the central bank gets advance warning of potential major problems for the payments system. That is why it is extremely important for a central bank or a supervisor to be able to conduct comprehensive and consolidated examinations of commercial banks.

I do not wish to get overly technical, but this issue has become more intense for us in the United States since Congress passed the Foreign Bank Supervision Enhancement Act. This law

basically governs whether an international bank can establish offices and do business in the United States, based largely on whether the bank is subject to comprehensive supervision and regulation in its home country. Although I believe the stringent rules of the Foreign Bank Supervision Enhancement Act are sensible, I also believe that Latin American countries should be inspired to overhaul their banking laws not merely because of this U.S. law. Rather, they should recognize that creating a strong financial structure is a good idea on its own merits--and, coincidentally, it can help with specific laws of other nations.

In addition, safe and sound banking practices are a prerequisite for joining the global financial system. While the Foreign Bank Supervision Enhancement Act came in response to the problems revealed by the collapse of BCCI, in a larger sense it represents a continuation of earlier moves toward international bank supervision. From the mid-1970s, we have seen a slow movement from the view that bank supervision is unilateral to the current view that it must be multilateral in order to protect the international banking system. This movement began with the formation of the B  le Committee in Switzerland in the mid-1970s, which was established in reaction to the failure of Herstatt Bank. We often think of B  le mainly as the source of international capital adequacy standards. However, the committee actually originally addressed itself to two propositions: that no foreign bank should be able to escape supervision and that supervision should be appropriate and consistent throughout the world. Currently, many other countries besides the G-10 countries have adopted the B  le capital requirements. I expect market forces will ultimately require banks of all countries, including those in Latin America, to meet the internationally agreed-upon capital rules.

The encouraging news is that many Latin American countries have already begun to overhaul their banking laws to bring their banking systems more into line with international standards of regulation. I am much encouraged by developments in Argentina, Colombia, Chile, and Mexico. But now comes the hard part--the actual implementation of these new laws. No matter how promising the plans for change are, the region still faces many problems. For instance, since the passage of the Foreign Bank Supervision Enhancement Act two years ago, the Federal Reserve has approved only two foreign bank applications from Latin American countries. One was from Banco de Chile and, just recently, I am pleased to say, from Banco de Galicia in Argentina. As of July, these two approvals compare with 17 other approvals in that same period for banks based in Asia and Europe. This comparison alone may be more revealing than anything else I say about the difficulties in the banking arena facing Latin American countries.

In this regard, although many Latin American countries have reasonably good bank supervision within their borders, generally the same attention has not been paid to offshore operations. Needless to say, such a situation prevents consolidated, comprehensive supervision and regulation of banks. Revisiting my comments on private property laws, it is fair to say that the fear of nationalization has created these complicated offshore business organizations in order to protect their assets from being seized by the government. Similarly, recurring bouts of high inflation have prompted bankers, business people, and residents to find useful ways to protect their income, leading once again to offshore operations and flight capital.

Now let me turn briefly to what continuing economic growth in Latin America means to the United States. Obviously, we are encouraged to see the great strides made toward market

economies, since the resulting stronger economies also create more opportunities for trade. It almost goes without saying that Latin America is a natural trading partner for the United States. Logically, if our neighbors to the south are doing better, so will we. We have already begun to see some fruits from the signing of the North American Free Trade Agreement (NAFTA) with Mexico, and the Administration seems to be talking about expanding NAFTA to other countries in Latin America. I am wholeheartedly in favor of such a move and look forward to the day when NAFTA extends to all of Latin America.

Without local banks that can meet international standards of safe and sound institutions, however, Latin American countries cannot be equal trading partners with other nations. Free and open trade goes hand in hand with a strong banking system, not only in the United States but also in each of our trading partners. The rejuvenation of Latin America can continue only with strong regulation from an independent supervisory body and strong banks--not just U.S., European, and Japanese banks but also strong Latin American banks.

Conclusion

In conclusion, Latin America already has begun to benefit from its market-based reforms as reflected by increasing external financing and stronger economic growth. Some observers might be tempted to say, though, that Latin America has always offered tremendous potential for growth, yet never translated this potential into full membership in the community of advanced economies.

As I have argued today, Latin America should finally be able to achieve its potential if its various countries incorporate into their reforms independent central banks, strong financial structures, and sound payments systems. I believe that many Latin American countries have made good progress toward these goals and that others will succeed in making the transition. Indeed, I look forward to more economic growth based on the successful implementation of additional economic, legal, and financial reforms. Such growth could catalyze true economic development that would transform the Latin economies into fully industrialized economies and increase prosperity for all members of society.