THE FINANCIAL SITUATION IN LATIN AMERICA AND IMPLICATIONS FOR THE SOUTHEAST

Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
Atlanta Council on International Relations
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Today, I would like to speak with you about the financial situation in Latin America. When we think about this topic now, foremost in the minds of many people is the sharp decline in the Mexican peso since December and the ensuing financial problems. This event has certainly colored the current financial situation in Latin America, but it would be difficult to understand the present state of affairs without some background information about the economic transformation Latin American countries have undertaken during the past few years. Time is too short for me to give a history of all the Latin American countries that have turned to market-based reforms, so I will concentrate my comments on Mexico. Doing so will not only set the stage for the main topic--the Latin American financial situation and its implications for the United States and the Southeast--but also lend some perspective to the discussion of the recent peso crisis.

Economic Reform in Mexico

For many decades, Mexico has been undergoing a far-reaching economic transformation. The revolution in Mexico in the early 20th century established a populist legacy that translated into an economy based on a considerable government role in the economy. In the 1970s and early 1980s, this legacy took the form of protectionist policies and excessive government intervention. High customs and tariffs characterized the Mexican foreign-trade scene, and the activities of

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foreign investors were severely limited. These conditions caused a number of undesirable consequences: capital flight, inflation, economic stagnation, and, above all, massive external debt. When oil prices began to fall in the 1980s, export earnings fell substantially and aggravated the debt problem in Mexico, as did high interest rates worldwide. These circumstances led Mexico to default on its international loans in 1982, an action that marked the beginning of what came to be known as the Latin American debt crisis.

By the late 1980s, Mexico's leaders realized that the future development of the country should not be based mainly on spending revenues from oil exports, and they began to lay the groundwork for a transformation to a more market-oriented economy. They began by lowering tariffs and then by introducing other market-oriented reforms, such as combining tight monetary and fiscal policies with price, wage, and exchange-rate controls. These reforms helped to eliminate the government budget deficit. The reforms also succeeded in reducing triple-digit inflation of more than 130 percent annually in 1987 to roughly 7 percent last year. Another important reform measure was the reduction of foreign debt through agreements with the International Monetary Fund, the World Bank, and its creditor banks. As a result, Mexico's external debt as a ratio of GDP was cut in half. In the meantime, the government started to privatize the large number of state-owned businesses, and the progress in this area has been nothing short of phenomenal. From a peak of 1,155 state-owned businesses at the end of 1982, Mexico had only about 225 as of mid-1992.

At the beginning of this decade, Mexico took even more steps to shift to free and open trade, which enabled it to join with the United States and Canada in the North American Free

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Trade Agreement in 1994. Joining NAFTA was highly significant for Mexico in that it affirmed that the country had officially emerged from the economic crises of the 1980s and indeed from its long-standing policy orientation toward protectionism that, at times, had bordered on isolationism.

All of these changes in Mexico--and in other Latin American countries as well--began to bear fruit by the early 1990s. Total foreign investment in Mexico doubled from 1991 to 1993. Manufactured goods as a percentage of exports grew to more than 80 percent in 1993. Growth in output had stabilized at a sustainable rate of nearly 3 percent last year. Moreover, foreign investors began to lend to Mexico for the first time since 1982. Thus, Mexico, like Chile, was held out as a model of economic reform by most observers, and officials from other countries consulted with government and central bank officials of Mexico to replicate its successes in their own countries. So then, what happened to lead to the events of December 20, 1994?

The Peso Crisis

Until December, the value of the Mexican peso had been controlled by the central bank and was linked, or pegged, to the value of the U.S. dollar by means of a controlled exchange-rate band. This exchange-rate regime helped Mexico to reduce its inflation rate significantly. However, the inflation rate in Mexico remained above the U.S. rate, and the controlled exchange-rate band did not fully compensate for that difference. This situation resulted in a gradual real appreciation of the peso. Over time, the real appreciation of the peso made foreign imports seem very cheap to Mexican consumers, which resulted in a consumption boom and a growing trade deficit.

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With hindsight, another problem with this exchange-rate regime is that it could not tolerate very well either errors in policy or unforeseeable events, or "shocks" as economists call them. Two political assassinations and the peasant uprising in Chiapas were one kind of unpredictable phenomena. They caused investors to lose confidence in Mexico because of the potential for political instability. Another unforeseeable event was the magnitude of the rise in U.S. interest rates in 1994. The Mexican government had been able to keep the peso within its bands by intervening in the markets with its currency reserves. These reserves had been accumulated by borrowing from foreigners, which was a reasonable strategy when interest rates were low. Rising interest rates, however, made this strategy of borrowing foreign funds to maintain reserves much more costly. The combination of these shocks resulted in a substantial reduction in the flow of capital into Mexico and a consequent loss of its foreign exchange reserves.

At any rate, on December 20, the central bank of Mexico allowed the peso to depreciate by 15 percent against the dollar, hoping that the peso would stabilize at its new lower value. Instead, the peso has fallen by roughly 40 percent against the dollar. The depreciation of the peso caused a financial crisis in Mexico and other emerging countries. The stock market in Mexico declined nearly 25 percent in peso terms yesterday [February 21]--its lowest point since December 20--and stock markets in Argentina, Brazil, Chile, and Peru also declined. Moreover, the depreciation caused interest rates in Mexico to soar. This effect could be seen in the interest rate on the so-called Tesobonos. (These are similar to our Treasury bills except that, although they are traded in pesos, their return is indexed to the dollar.) The interest rate had increased to

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as much as 25 percent from 7 percent in June. Meanwhile, we have since learned from a report released by the central bank of Mexico that currency reserves were falling to a perilously low level.

Response to the Mexican Crisis

The Mexican government and the international community both responded to this situation. In Mexico, President Zedillo announced an emergency economic plan on January 3 after two weeks of negotiations with business leaders, trade unions, and creditors. However, when it appeared that this plan was not enough to quell international concerns, President Clinton first proposed a plan for aid to Congress. It did not move quickly through Congress, so the president then used an executive order to provide U.S. aid to Mexico and combined it with international aid from Canada, four Latin American countries, the International Monetary Fund (IMF), and the Bank for International Settlements. The resulting $50-billion aid package seems to have quieted initial concerns about Mexico's ability to cope with the problems, and the Tesobono rates have come down to 17 percent. (This number does not include results from today's [Feb. 22] auction.)

Yesterday, U.S. Treasury Secretary Robert Rubin and Mexico's Finance Minister Guillermo Ortiz officially signed the agreement. Although it contained a number of conditions that Mexico must meet in terms of macroeconomic policy, the markets did not respond favorably. Both the Mexican stock market and the peso fell.

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There are many views of the Mexican situation, and its causes and consequences will be debated for some time. However, I would like to stress that the fundamentals in Mexico remain positive. This emerging country is basically sound, and I believe it will persevere through its latest economic problems. However, in the short term, I believe strong backing from the United States, which is Mexico's largest trading partner, was absolutely necessary in order to restore confidence in the ability of the Mexican government to handle the financial situation.

Moreover, I believe it is critical to recognize that financial difficulties of this sort can be expected from time to time in a world that is more tied together through the globalization of finance. While many countries have benefited from the increase of capital flows around the world, it is also true that capital is not fixed. It can just as easily flow out as well as flow into a country. Mexico has felt both sides of this force, as have other countries, including several in Europe in recent years. The point is that isolation is not a better alternative. The benefits of worldwide trade and financial linkages far outweigh the costs associated with this type of crisis.

The Latin American Situation

It probably goes without saying that it is much harder to be certain about an economic outlook for Latin America since the depreciation of the Mexican peso. The current situation in Mexico has clouded the short-term economic and financial outlook for that country and possibly for some others in Latin America. In any event, I must emphasize that the longer-term outlook remains positive for the region as a whole, largely because most Latin American countries have embarked upon programs of similar market-oriented reforms and trade liberalization.

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Now let me give a brief overview of the outlook for most of the countries in Latin America for 1995. In **Argentina**, growth will likely slow to around 3 percent this year after a growth rate of 6 percent in 1994. Continued growth depends largely on Argentina's ability to continue to attract foreign capital. The Mexican crisis may have a negative effect in this regard, at least in the short term, since many overseas investors have become more hesitant to invest further in emerging markets at this time. Consumer inflation was just under 4 percent last year--the lowest in more than 50 years and the lowest in South America in 1994. Continued fiscal discipline should keep this rate near 4 percent this year.

Brazil, the economic giant of the region, should see real economic growth rise to nearly 5 percent this year from just over 4 percent in 1994. For years, the inflation rate in Brazil has been truly astronomical--at more than 1,000 percent. Thanks to the "Plano Real," the inflation rate should fall below 100 percent this year. Continued success on the economic front depends largely on political reform, namely constitutional reforms that will help restrain fiscal spending. Brazil set out on this path by electing a pro-reform president last year.

Chile, the next member-elect of an expanded North American Free Trade Agreement, continues to be the shining star of Latin America. Growth should be in the 5 percent range in 1995, up from nearly 4 percent last year. Chile's prudent economic policies have enabled the country to post positive rates of growth averaging 5 percent over the last decade. Inflation in Chile could fall to 8 percent this year from nearly 9 percent in 1994. Chile has a high domestic savings rate and a financial system that is less susceptible to destabilizing outflows of capital.

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Both of these attributes should help it through the fallout from the Mexican peso depreciation. Overall, Chile is an example of a country benefiting from the kind of economic and political stability other Latin American nations are striving toward.

Venezuela is now struggling after having had such a promising outlook before the bankruptcy of its second-largest bank, Banco Latino, and the subsequent de facto nationalization of its banking system in 1994. The Venezuelan economy contracted more than 3 percent last year and is not likely to post positive growth in 1995. Consumer prices jumped by 70 percent last year, and this performance should improve only slightly in 1995.

In **Bolivia**, real economic growth should remain between 4 percent and 5 percent in 1995. Investment and export growth are expected to lead the way in boosting Bolivia's economy this year. Prudent fiscal and monetary policies should push the inflation rate to below 7 percent from the 8-1/2 percent rate of last year.

In **Colombia**, the economy will probably grow near last year's 5 percent level. Higher social spending should continue to spur growth, but these programs are likely to limit progress on inflation. Consumer prices should rise around 20 percent in 1995, down only slightly from 1994.

Peru has had a sparkling economic performance over the past few years. Its economy grew by more than 12 percent in 1994 and should grow nearly 8 percent this year. But this

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performance has been tainted by the armed conflict with **Ecuador** over the disputed border region.

In sum then, conditions in Argentina and Brazil are fundamentally sound, with Brazil having made a remarkable policy turnaround over the past year or so that has helped to bring inflation down. Chile, Colombia, and Peru are likely to outpace the other countries, with GDP gains of between 5 percent and 8 percent. Inflation for Latin American countries should decline further in 1995 as long as sound fiscal and monetary policies are pursued.

Implications for the United States and the Southeast

Now let me discuss briefly what this overall growth in Latin America means to the United States, and particularly to the Southeast. Obviously, it is encouraging to see these positive forecasts since Latin America is a natural trading partner for the United States. Logically, if our neighbors to the south are doing better, so will we. But what exactly do I mean by "doing better"? At the most fundamental level, it means more jobs--jobs in the United States and jobs in Latin America, all tied to increased trade. According to the Commerce Department, U.S. manufacturing exports to the world increased by 95 percent in the period between 1987 and 1993, whereas they increased by 138 percent to Latin America and the Caribbean. Argentina, Chile, Colombia, and Mexico saw the greatest increases in manufacturing exports from the United States during that period. Unlike the vicious cycle of retaliation that protectionism leads to, free trade creates jobs in a virtuous cycle, making all countries better off. In addition, people in countries that trade freely with one another are able to purchase goods and services that would

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not otherwise be available to them.

Another important aspect of trade is proximity. Countries that are close geographically typically have more opportunities to trade. Since the Southeast is closer than the most of the rest of the United States to Latin America, it ought to be able to benefit even more from increased trade with Latin America. Some other export statistics also suggest that the United States and the Southeast can benefit from concentrating on certain exports to Latin America. According to statistics from the Inter-American Development Bank on exports to Argentina, Brazil, Chile, and Mexico, from 1990 to 1993 the fastest-growing areas, in terms of value-added, were construction, transportation, communications, electricity, gas, and water, financial services, and wholesale and retail trade. Some of these are industries in which businesses in the Southeast have a comparative advantage--and many have already begun to do more trading with Latin American countries.

However, with all the positive things I have said about the Latin American transformation and what it means to the United States and the Southeast, I do have some concerns about future growth in Latin America. My main concerns have to do with the financial and legal systems in Latin America. Because the world is driven increasingly by technology that links countries more closely, unsound banking practices pose threats to more than the home country. For instance, the failure of Banco Latino in Venezuela and its affiliates in the United States and Curaçao did not affect the U.S. system. Yet it did raise serious concerns about possible problems that may arise when proper supervisory and regulatory controls are not in place. The collapse of BCCI is

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another obvious example of unsafe banking practices that have the potential to disrupt banking systems and their customers around the globe.

In order to ensure the security of the international banking system, it is important that all countries have an independent supervisory authority and that all financial institutions be subject to comprehensive and consolidated supervision. Personally, I believe that the central bank should perform these roles. The reason is that central banks take the larger view and tend to focus on the safety and soundness of the whole banking system. Also, there has been a necessary move toward making these institutions independent, and my main point is that the entity responsible for bank supervision must not be vulnerable to political pressure.

A closely related challenge pertains to legal reforms. Among the evolving economic and political reforms taking place in many countries, one area that has not yet become firmly implanted concerns private property and contract law. In the industrialized world, 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 should, in my opinion, be met. Otherwise, private and corporate citizens, as well as foreign investors, 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. In this regard, although many Latin American countries have reasonably good bank supervision

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within their borders, generally the same attention has not been paid to offshore operations. It is fair to say that the fear of nationalization has created these complicated offshore business organizations in order to protect assets from being seized by the government. Obviously, such a situation prevents consolidated, comprehensive supervision and regulation of banks.

Conclusion

In conclusion, the transformation of Latin America over the past decade or so has created a new emerging market in the world economy. From the U.S. perspective, we could not be more pleased because economic growth in Latin America will have a positive effect on the United States and the Southeast. As economic growth leads to increased incomes in Latin America, it will, in turn, lead to more trade that increases the incomes of U.S. citizens through job creation.

While I see several significant challenges that must be met by Latin American countries in order to translate their tremendous potential for growth into full membership in the community of advanced economies, I also firmly believe that this emerging region is fundamentally sound. With a view toward the long term, I am optimistic that Latin America will continue on the road of market-based reforms it has set out upon and that the region's success will enhance the economic prospects of the United States and the Southeast.

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