

BANCODE **ESPAÑA**

Madrid, 26 October 2005

Introductory Speech to the XI “LAC Meets the Market” Conference

The World Bank - Banco de España

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Señor Secretario de Estado de Economía, Vice-Presidenta del Banco Mundial, Gobernadores, señoras y señores:

Es un placer y un privilegio para el Banco de España ser la sede en la que se celebra esta importante Conferencia, que reúne a un muy destacado grupo de representantes del sector privado, de instituciones nacionales e internacionales y de la comunidad académica, para analizar las perspectivas económicas latino-americanas.

Ladies and gentlemen,

It is a pleasure and a privilege for the Banco de España to host here today the Eleventh 'LAC meets the Market' Conference which, for the first time, is being held in Europe. This very important event also happens to be taking place shortly after the conclusion in Salamanca of the XV Iberoamerican Summit, which saw a very fruitful exchange of views on a range of institutional, social and economic issues which are critically important to the future of Latin America.

The choice of Madrid to host today's Conference –for which we wish to thank the World Bank– also reflects the interest of Spain in ensuring an ongoing dialogue between Latin America and Europe and, in the case of the Banco de España, it underscores the importance that our institution attaches to the region.

Indeed, in recent times the links between Spain and Latin America have gone beyond the cultural and historic sphere to extend to the economic arena. Admittedly, commercial ties are not very intense, but over the nineties the flow of investment in Latin America was very important. The relevance of this process is difficult to overstate, to the extent that one can say that Latin America has been the main lever, together with Europe, of the intense internationalisation of Spanish firms that has taken place in the second half of the last decade.

These reinforced links with Latin America led our institution to closely monitor the economies in the zone and to increase our collaboration with our Latin-American colleagues. This has allowed us to perform efficiently the supervision of Spanish banks and to make our own assessment of the Latin American economies, which we also disseminate to the public through our research and regular publications.

Beyond Spain, the economic links between Europe and Latin America are noteworthy. For a number of countries, like Brazil or Argentina, exports to the European Union represent around one third of the total. In turn, the share of foreign direct investment from Europe is substantial: almost half of that in the last decade was from the European Union, with Spain concentrating sixty per cent of European investments.

Furthermore, Latin America is very prominent as concerns financial markets, and more specifically debt markets. The Latin American zone was the main issuer of international debt

among emerging economies in the international financial markets during the nineties, although since 2001 Latin America has been surpassed by Asia and, at some point, also by Eastern European countries. In spite of this, the outstanding stock of Latin American securities in the emerging markets stands at around 350 billion dollars, i.e. more than forty percent of the total, with Brazil and Mexico far ahead in the ranking.

The reason for this large weight is due to a confluence of factors: the process of financial liberalisation in the nineties, both in the developed and emerging markets; the Brady Plan, which triggered a new phase in the development of emerging debt markets; and the secular lack of domestic savings in the area. All the above factors led supply and demand to meet in a flourishing international debt market.

Indeed, the success of this market entailed the extensive availability of funds for the Latin American economies, which was an important factor for the economic progress of the area at the beginning of the nineties. However, this abundance of foreign funds also contributed to some economic excesses. The flood of capital flows not only tended to generate economic overheating and the accumulation of external disequilibria, but also allowed unsound fiscal policies to be financed in a number of cases. When those imbalances became evident, capital flows retreated as forcefully as they had come in, contributing to the sequence of financial crises – sometimes accompanied by banking crises – that have plagued the zone in the second half of the nineties and beginning of the new century.

The dire financial costs and deep-seated economic slowdown that followed were characterised by disappointment within the region and reluctance to invest by external creditors and investors. In the ensuing years, a common complaint in the area was that it had been falling into oblivion. However, this seems to be over now. In the last year or so, interest in Latin America has revived, supported by good domestic economic performances and reforms, but attributable to some extent to very favourable external financing conditions. This is not only the case of Latin America but also of other emerging regions, such as Central and Eastern Europe, particularly the new EU Member States, and Asia.

Today you will have the opportunity to discuss in a privileged context the prospects for Latin American emerging markets. Thus, I do not want to elaborate too much on the economic situation of the area since you will be discussing it in depth in the first session of the Conference. Furthermore, a quick regional overview would do no justice to the marked differences existing from one country to another.

It is a fact, however, that the pessimism prevailing until very recently has been followed by marked optimism, and that such dramatic swings of opinion generally lead to biased conclusions in the analysis. Therefore, I would just like to highlight three elements which I deem relevant to obtain a more accurate picture of the current situation in Latin America. The first

signals genuine progress, the second is an obvious improvement which must be judged with caution, and the third is a source of concern.

First, the genuine good news. The advances in economic stability observed in the region are excellent news. It can be said that Latin America has successfully moved to a regime of low inflation after the abandonment of the rigid exchange rate regimes of the nineties. The new monetary frameworks, based on managed floating and, in most cases, inflation targeting strategies have bolstered the anti-inflationary credibility of central banks. Fiscal policies have become more disciplined in the last few years and the debt structure has improved, moving towards a larger domestic share and a smaller proportion of dollar, or exchange-rate-indexed, debt. In addition, the banking system – following reform and privatization – is today stronger and more resilient in many countries. These developments suggest that certain lessons have been learnt from the past and that the principles of economic rectitude are increasingly gaining ground.

The observed reduction in the financial vulnerability of the region, which you will be discussing in the second session of the Conference, is another element I wanted to stress. Undeniably, by any measure, financial vulnerability has decreased in the last few years. Furthermore, policymakers have made a genuine effort to reduce the vulnerabilities through a stronger commitment to fiscal discipline and a proactive debt management. In this respect, a particularly positive development on the Latin American financial landscape has been the recent deepening of local bond markets, which also contributes to strengthening countries' financial positions.

Notwithstanding, it is important to acknowledge that these developments have also been fostered by increasingly favourable external conditions, characterised by strong demand for the raw materials produced by Latin American countries and by an improvement in financial market sentiment towards the region and the search for yield. This has contributed to the strength of the domestic currencies, the reduction of interest rate spreads and the ability of countries to restructure the stock of liabilities and to further issue local currency debt. It also means that the improvement in financial vulnerability indicators observed in recent years could be at least partially reversed in the event of a substantial worsening in market sentiment as a result of unfavourable external or domestic developments. This is obviously also the case in Asia and Central and Eastern Europe, but there are underlying differences which would make such an event more harmful in Latin America. Among such differences, I would highlight the stubbornly high levels of debt compared to the other two areas, the lack of an external anchor as in the case of the new EU Members, and lower potential growth, at least compared to most Asian countries.

Finally, a source of concern in Latin America, in my view, is that the economic authorities are, in a number of cases, not taking full advantage of the current, very favourable external and domestic environment to push decisively ahead with a renewed reform agenda. The unpopularity of reforms in quite a few countries, after they were perceived as failing to deliver

the benefits promised to citizens, have acted as a major deterrent. After all, if Latin America has returned to strong growth, why pursue reforms which may be difficult to sell and thus be politically costly?

Nevertheless, the case for strengthening the reform process becomes evident once we take a wider perspective. Although in 2005 the area is expected to grow at a rate of 4,5%, after having grown at 6% last year, this performance is not outstanding when compared to other more dynamic emerging market zones, which is particularly worrying given the still low per capita income levels in Latin America. Moreover, in spite of all the talk about the renewed attractiveness of the region, foreign direct inflows are still well below the levels in the nineties, and, overall, Latin America is exporting capital, as its current-account surplus testifies. This means that a number of countries in the area are not yet as attractive for international investors as it may seem, even in the current good times, compared to other emerging markets. One prominent example is China, but there are other emerging markets which are regarded to be in a favourable position, like India or the new EU members. You will be discussing such issues in the third session of today's Conference, but I believe that these observations only emphasise the need to avoid complacency and press more energetically ahead with policies that increase the growth potential of the various national economies.

Latin America has a bright future ahead. But this will only materialize if stability-oriented macroeconomic policies continue to be pursued and the much-needed reforms advance. That will allow for more rapid sustained growth while reducing vulnerabilities and the high degree of economic inequality present in most countries of the area,

I would like to conclude by stressing the importance of having an accurate and in-depth view of the different economies in the region since the general messages I have offered you in these few minutes should be qualified to a certain extent depending on the country. Our Conference today is especially suited to achieving this goal, since this "LAC meets the market" is a unique occasion on which investors, academics and policymakers as prestigious and representative as those gathered here today can discuss the economic and financial situation and prospects of Latin American countries. For the Banco de España it is a pleasure to have worked together with the World Bank in organising this meeting and to hold it in our premises. I hope you will all enjoy it.

Thank you.