



CENTER FOR
LATIN AMERICAN
MONETARY
STUDIES
Regional Association of Central Banks

Capital Flows to Latin America: Policy Challenges and Responses

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INTERNATIONAL CAPITAL MOVEMENTS: OLD AND NEW DEBATES
Cusco, July 19-20, 2010.

1. Introduction

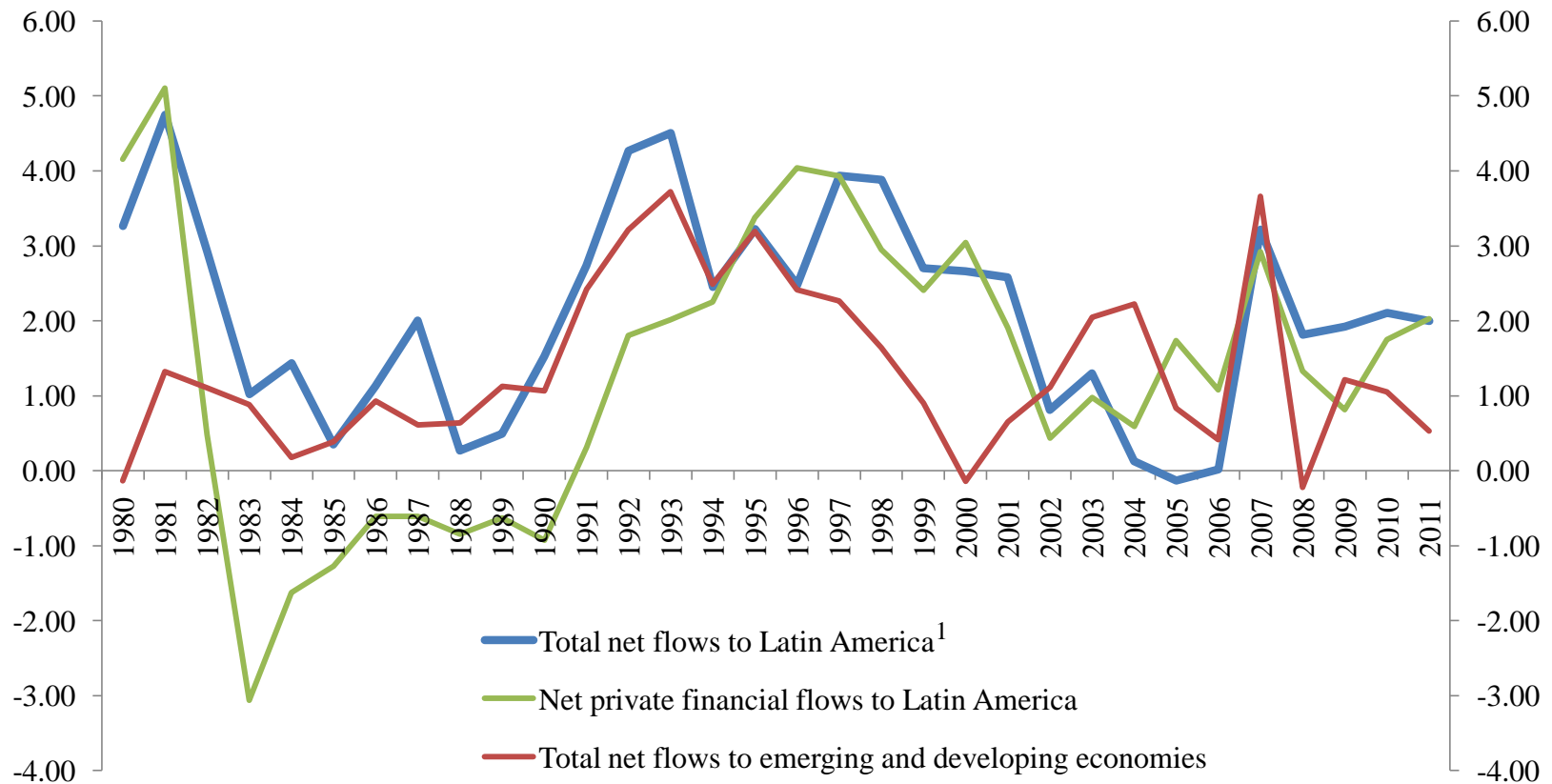
- Capital flows to Latin America and other emerging market economies fell sharply after the collapse of Lehman Brothers in September 2008.
- The rapid implementation of measures aimed at facing the impact of the crisis, combined with the efforts made by the international community, allowed a gradual return of access to international financial markets.
- By the end of 2009, sovereign and corporate bond issues had reached levels above those observed on average in 2006-2007, and the region's stock of international reserves rose to record highs.
- Capital flows have continued to increase, in a context of high volatility, during 2010.

- This presentation will focus on the following questions:
 - ✓ What are the main differences between the current and previous episodes of capital inflows?
 - ✓ To what extent are conclusions for the region consistent with those for individual economies?
 - ✓ Is Latin America better prepared to face the challenges resulting from capital inflows?
 - ✓ Have proper measures been implemented as a response to the recent resumption of capital inflows?

2. Differences between the current and previous episodes of capital inflows

First, it is not clear whether the phenomenon we are witnessing today represents the beginning of a new episode of comparable magnitude to those observed in the past 30 years.

Net Capital Flows to Emerging and Developing Economies and to Latin America % of GDP



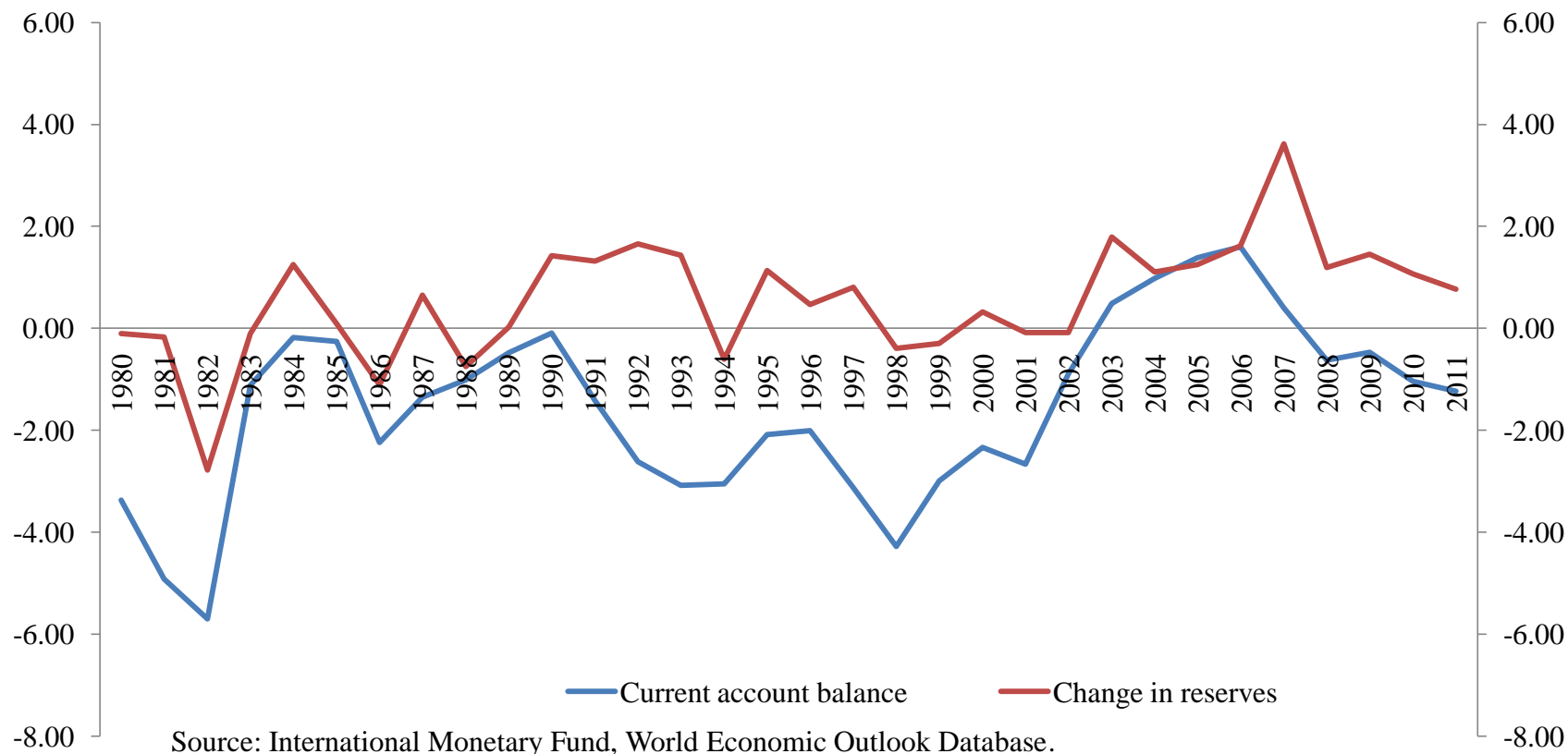
Source: International Monetary Fund, World Economic Outlook Database.

¹ Includes errors and omissions.

- Furthermore, there is a risk that capital flows to emerging market economies prove to be short lived this time.
- The tightening of monetary policy in advanced countries, coupled with the demand for resources resulting from a cyclical upturn and very high budget deficits in these economies, could crowd out emerging market borrowers.
- The predominant view is that interest rates in the main industrial economies will remain low for a relatively long period, and therefore the main concern for emerging economies is capital inflows and their volatile behavior, rather than outflows.

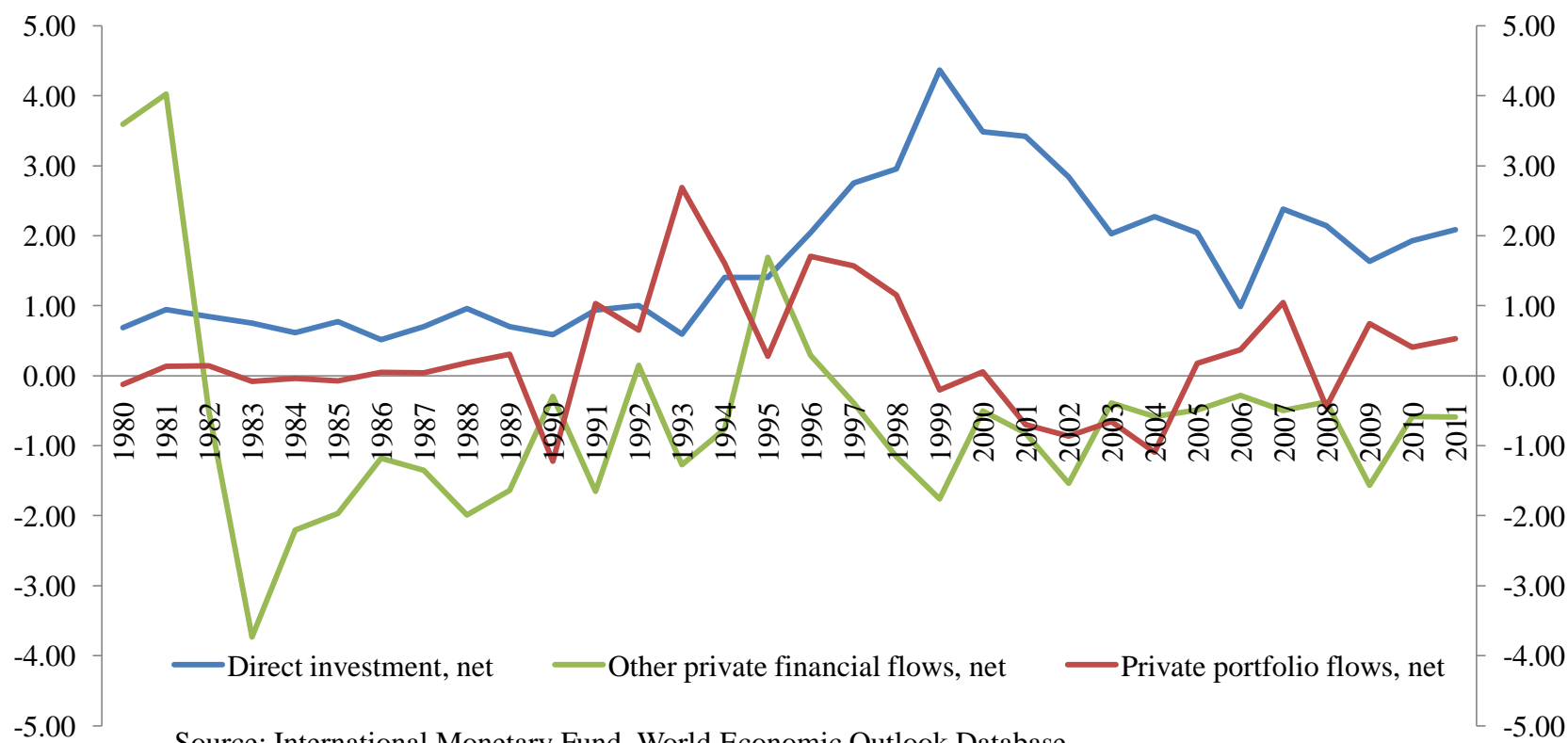
Second, the counterparts to capital inflows have varied over time. At present, they are financing moderate deficits in the current account and a continued accumulation of international reserves.

Latin America: Current Account and the Variation of International Reserves % of GDP



Third, the composition of capital inflows to Latin America has changed substantially over the last thirty years.

Latin America: Composition of Private Capital Flows % of GDP

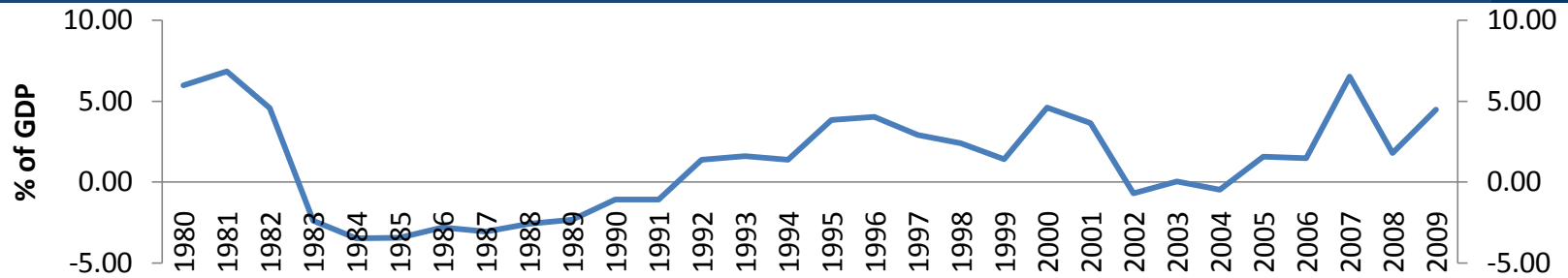


Source: International Monetary Fund, World Economic Outlook Database.

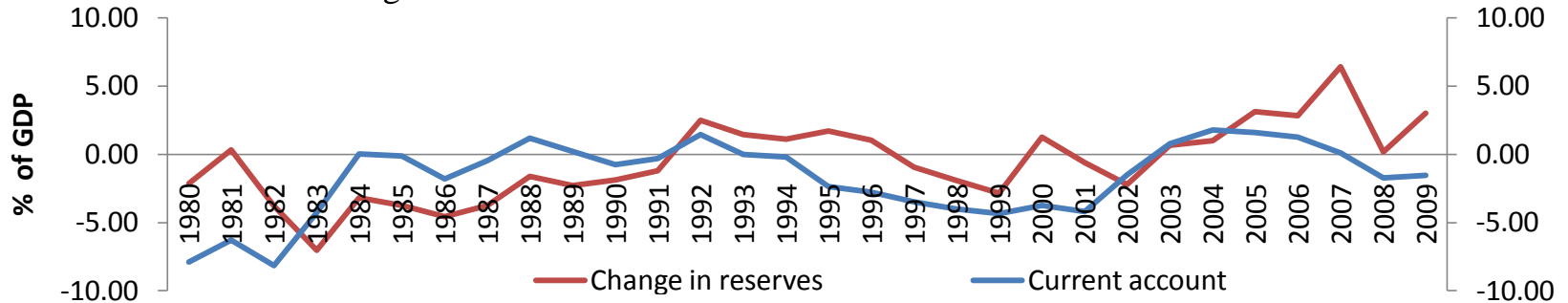
3. The experience of individual countries

- These general trends are accompanied by differences among individual countries, as shown by the case of those economies considered by the IMF “with strong links with international financial markets” (Brazil, Chile, Colombia, Mexico and Peru).
- For instance, in the cases of Brazil and Colombia, capital inflows are sizable and not far below those observed during previous episodes.

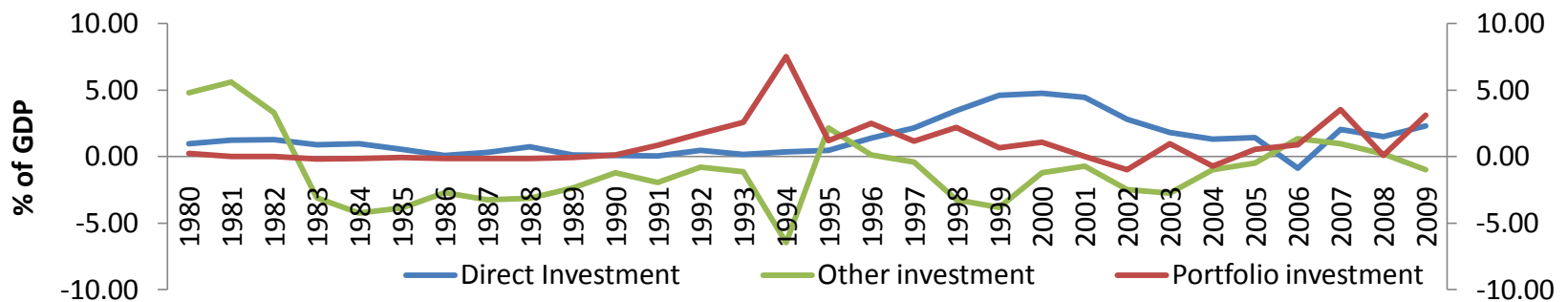
Total Net Capital Flows



Current Account and Change in International Reserves

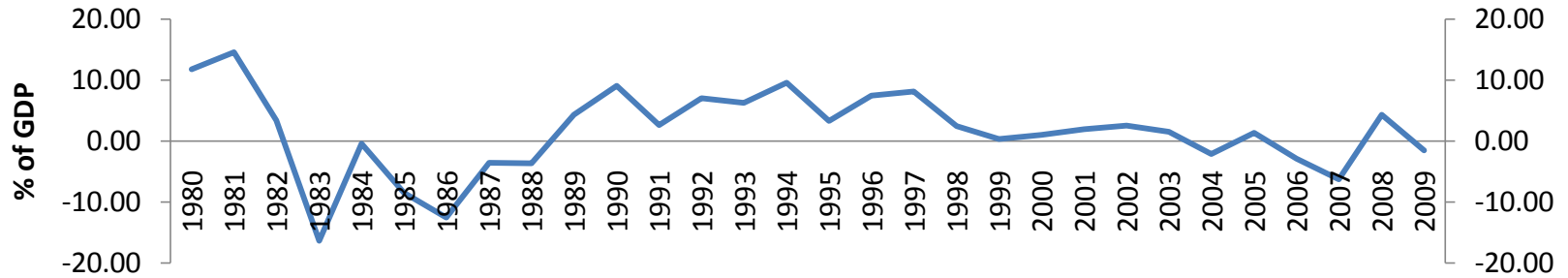


Financial Account Components

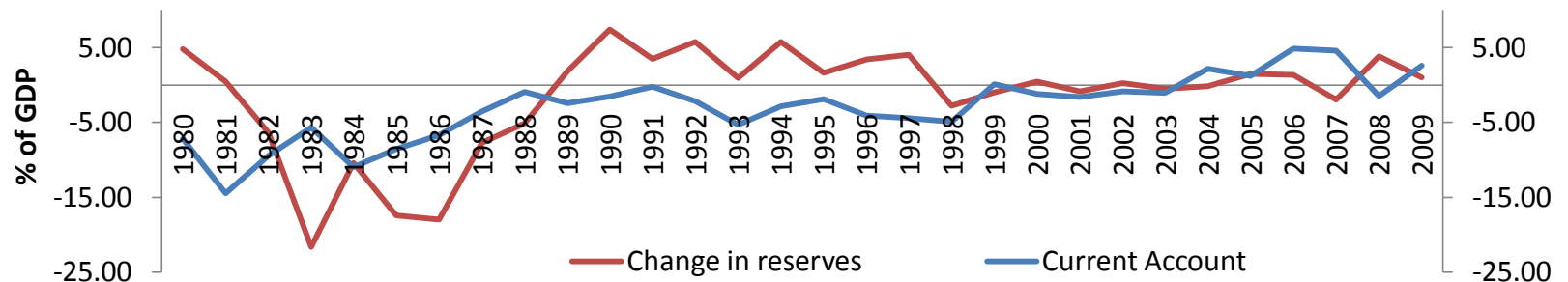


Source: International Monetary Fund, International Financial Statistics.

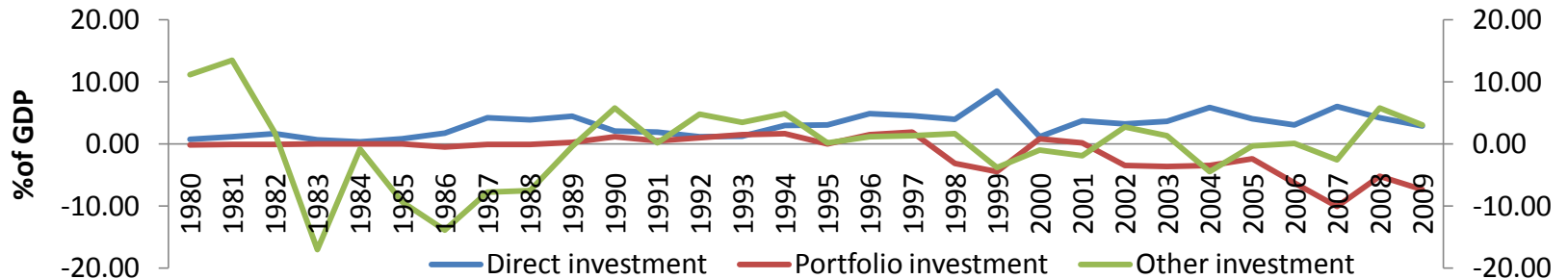
Total Net Capital Flows



Current Account and Change in International Reserves

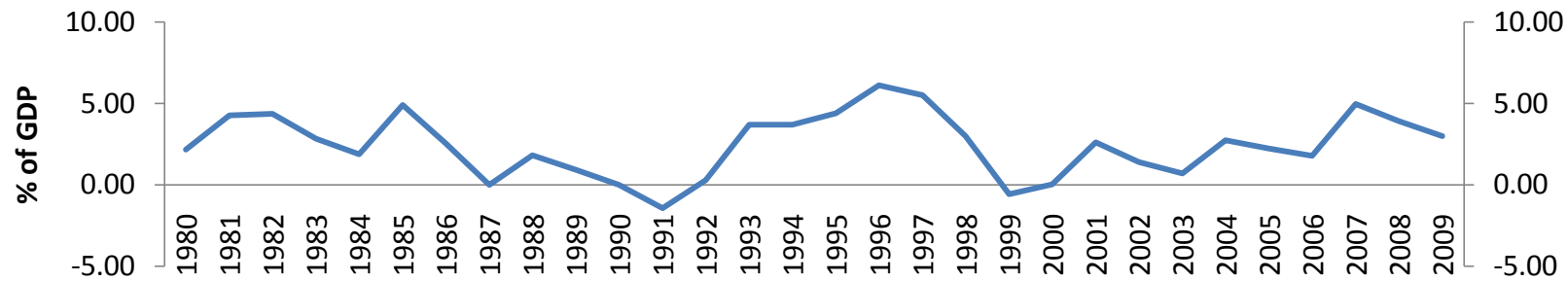


Financial Account Components

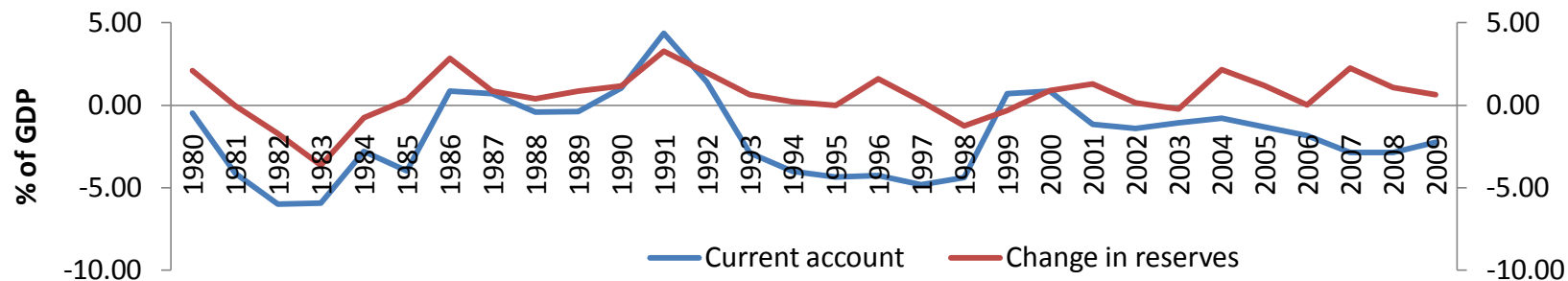


Source: International Monetary Fund, International Financial Statistics.

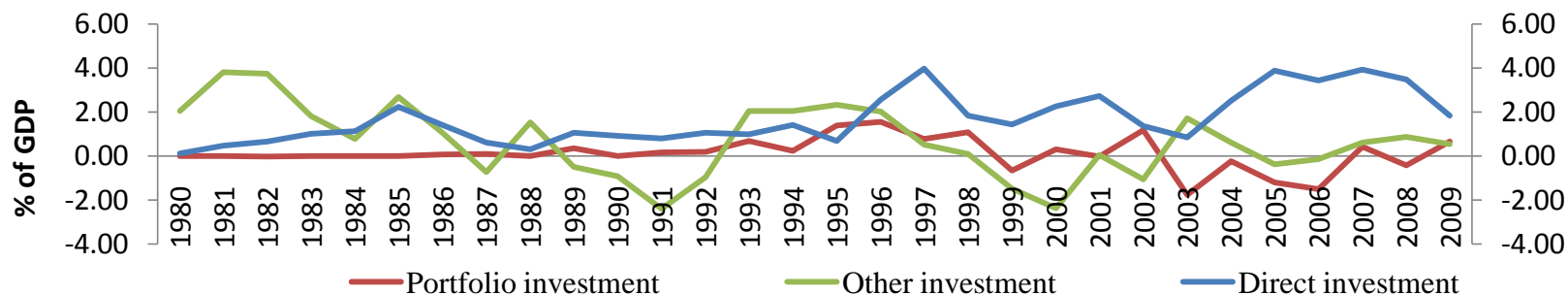
Total Net Capital Flows



Current Account and Change in International Reserves

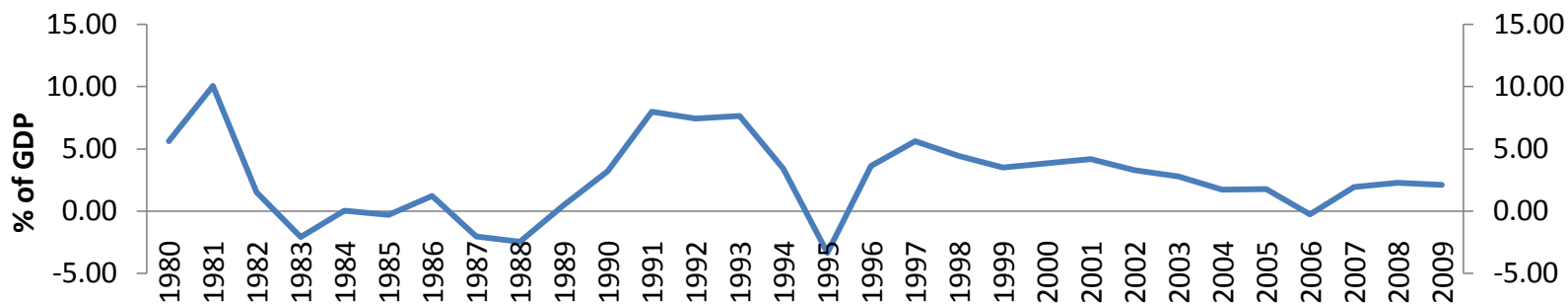


Financial Account Components

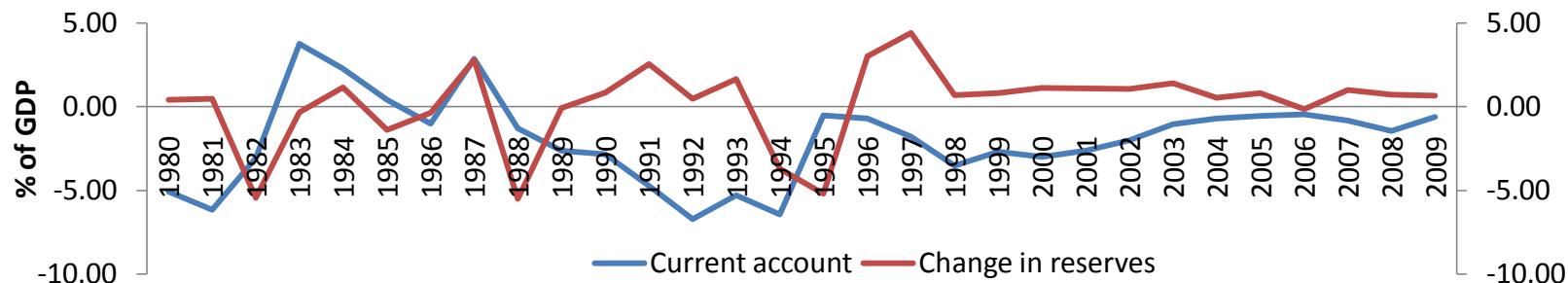


Source: International Monetary Fund, International Financial Statistics.

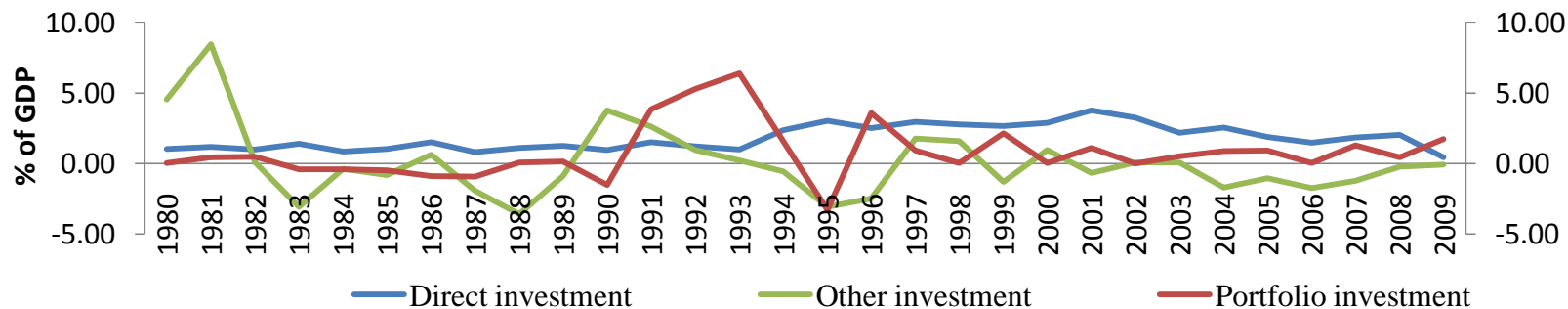
Total Net Capital Flows



Current Account and Changes in International Reserves

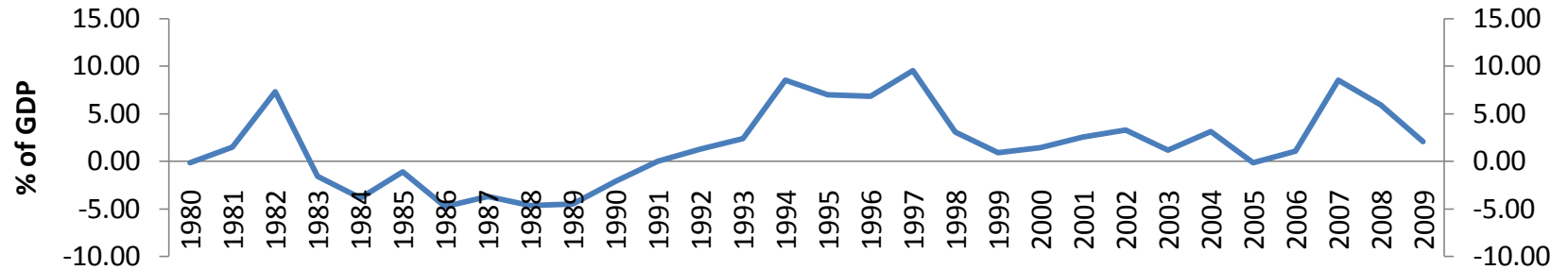


Financial Account Components

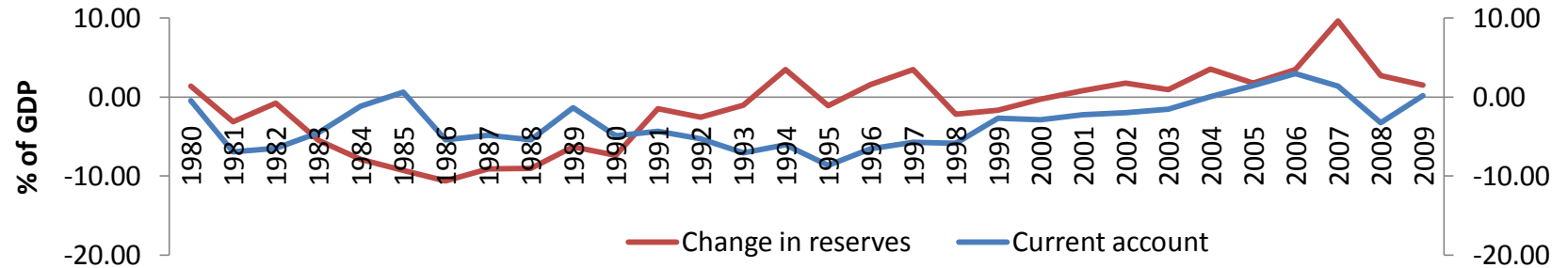


Source: International Monetary Fund, International Financial Statistics.

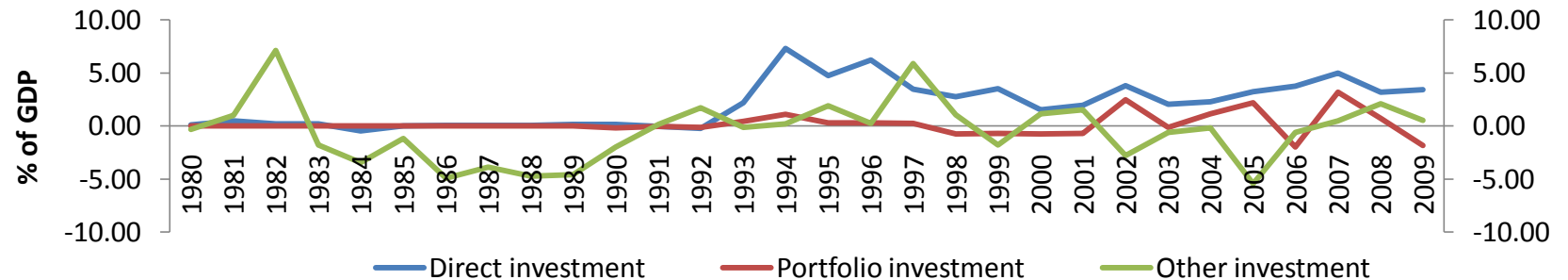
Total Net Capital Flows



Current Account and Changes in International Reserves



Financial Account Components



Source: International Monetary Fund, International Financial Statistics.

- However, overall, the conclusions regarding the use of those inflows and their composition are similar to those reached at the aggregate level:
 - 1. Capital inflows are financing reserve accumulation and more moderate current account deficits than in previous episodes of substantial inflows, and
 - 2. Either they are dominated by direct foreign investment or FDI represents a substantial share of total inflows.

4. Is Latin America better prepared to face the challenges resulting from capital inflows?

- Two of the five countries “with strong links with international financial markets” have been approved a Flexible Credit Line by the IMF, a facility designed for economies with very strong fundamentals, policies and track records of policy implementation.
- There is a widespread perception that the other three would be granted one, if requested.

Furthermore, four of these countries have achieved investment grade status.

Investment Grade Status

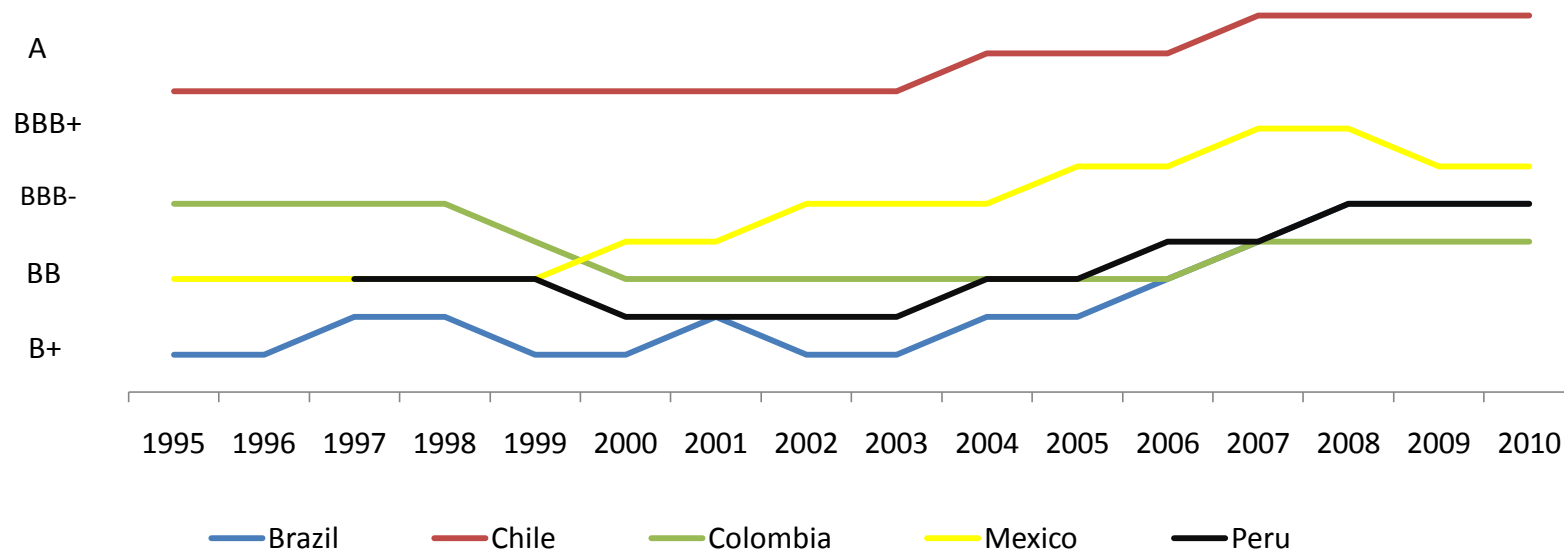
Country	1995	2000	2002	2008	2010 ¹	Outlook
Brazil	-	-	-	√	√	Stable
Chile	√	√	√	√	√	Stable
Colombia	√	-	-	-	-	Positive
Mexico	-	-	√	√	√	Stable
Peru	-	-	-	√	√	Stable
Total	2	1	2	4	4	

Source: Standard & Poor's

1) Investment grade rating for long-term sovereign debt in foreign currency. Information for July 15, 2010.

...and despite the difficulties resulting from the global crisis, ratings have not in general been affected.

Ratings by Standard & Poor's



Source: Standard & Poor's

In addition, all these countries operate under flexible exchange rate regimes.

Countries with Floating Exchange Rate Regime

Country	1980	1985	1990	1995	1999	2000	2005	2010
Brazil	-	-	-	-	√	√	√	√
Chile	-	-	-	-	-	√	√	√
Colombia	-	-	-	-	-	√	√	√
Mexico	-	-		√	√	√	√	√
Peru	-	-	√	√	√	√	√	√
Total	0	0	1	2	3	5	5	5

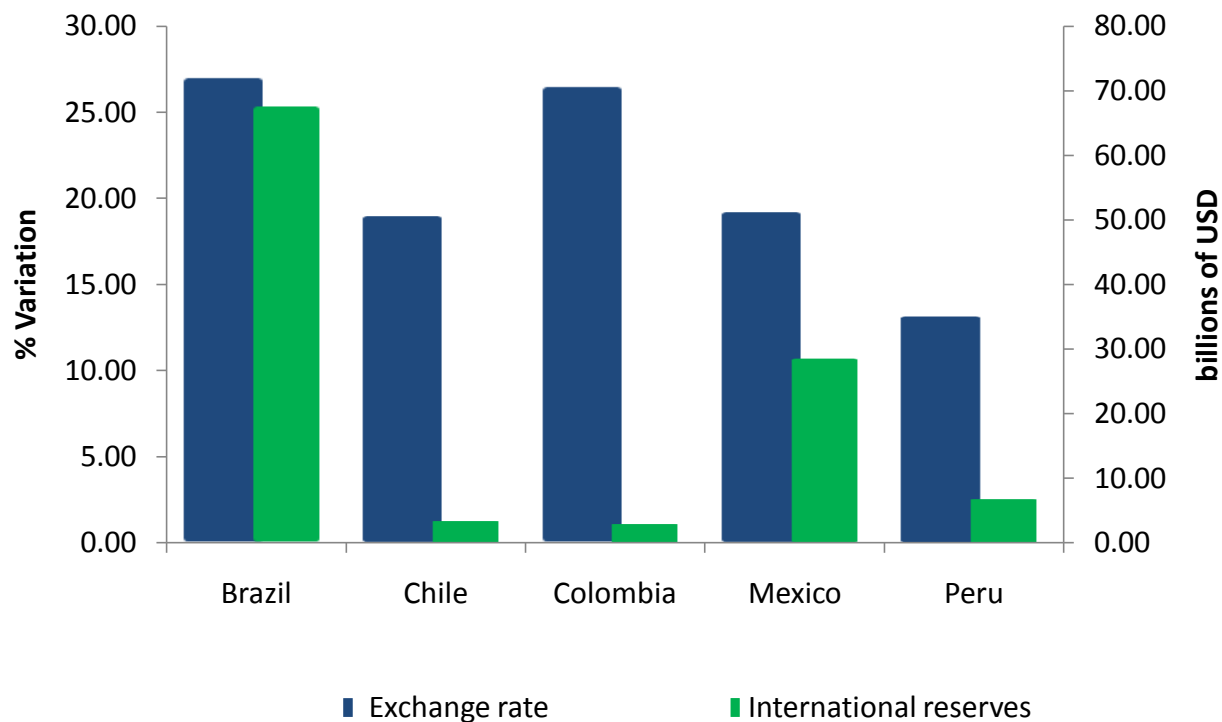
Source: International Monetary Fund, Exchange Arrangements & Exchange Restrictions, Annual Reports.

- According to the IMF, Latin American financial systems overall are much better prepared and more resilient than in the past.
 - ✓ “Most banking systems in the region have capital adequacy ratios well above international standards (median of around 15 percent), low non performing loan ratios (median level of 2.5 percent), high return on equities (median of 2 percent a year), balanced or positive net foreign asset positions, and adequate liquidity ratios (median of 20 percent of total assets)”.
- Thus, it is not surprising that no Latin American banking system faced a crisis during the recent period of global financial turmoil.

5. Have proper measures been implemented as a response to the recent resumption of capital inflows?

- The policies adopted vary substantially from one country to another.
- However, the appreciation of the exchange rate and the accumulation of international reserves have been a common response.

International Reserves¹ and Exchange Rates²



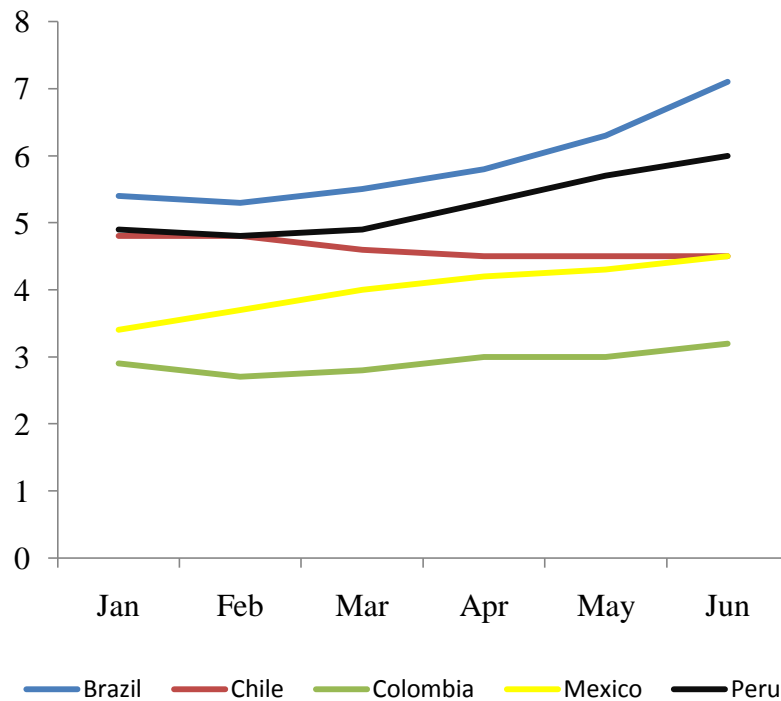
Source: National central banks.

1. Variation from the lowest point in 2009 to the highest in 2010 (billions of US dollars)

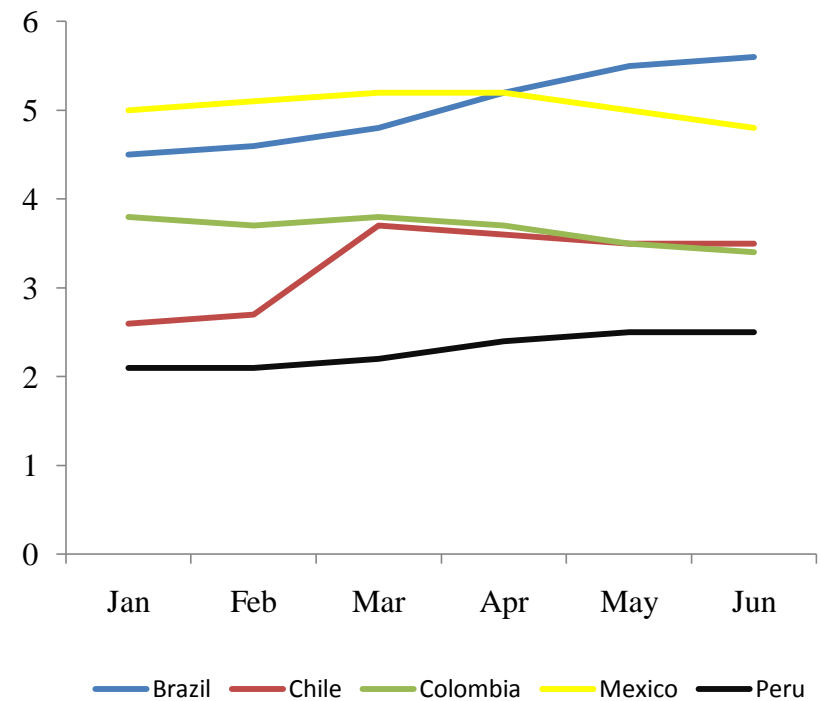
2. Percent variation from the most depreciated level in 2009 to the most appreciated in 2010.

Judged by market expectations on the behavior of the main macroeconomic aggregates, it can be argued that the measures adopted have been successful in meeting the objectives sought.

Economic Growth Expectations for 2010

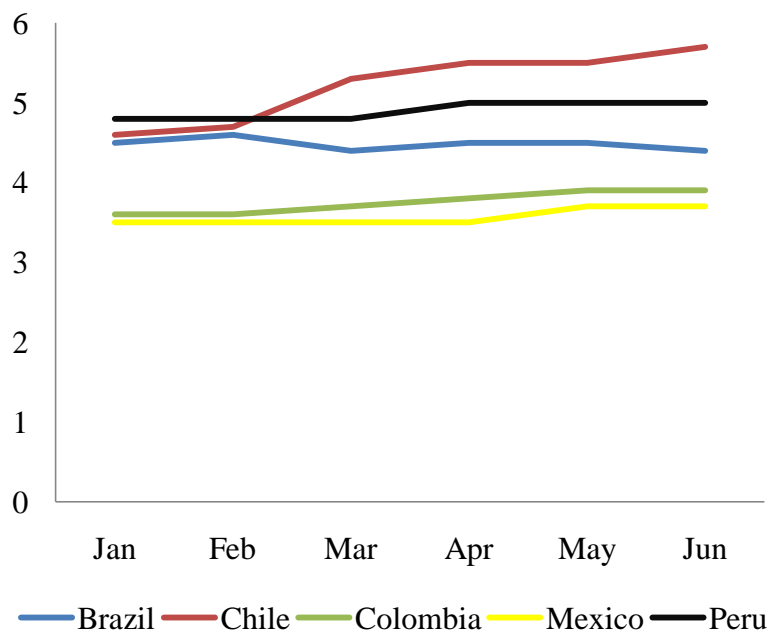


Inflation Expectations for 2010

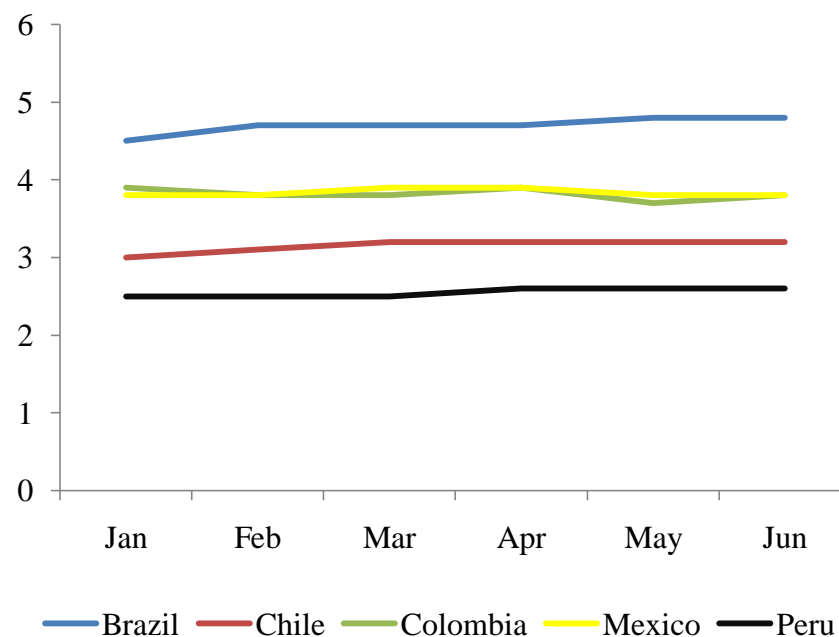


Source: Latin American Consensus Forecasts.

Economic Growth Expectations for 2011



Inflation Expectations for 2011



Source: Latin American Consensus Forecasts.

6. Final remarks

- Although the size of capital flows to Latin America has not reached the magnitudes of previous episodes, the most exposed countries of the region are better prepared to face these inflows, and the measures adopted thus far seem to be working well, it would clearly be a mistake to relax the stance:
 - ✓ The international economic situation remains very complex and projections are subject to an above normal degree of uncertainty.
 - ✓ Also, the responsiveness of capital flows to changing conditions is very high and likely to increase even more.
 - ✓ As shown by the recent experiences of Brazil, Mexico and other emerging economies, financial innovation can give rise to operations beyond the authorities' control, which have the potential to lead to unpleasant surprises.
 - ✓ There is a significant variation of experiences among countries in the region.

6. Final remarks

- Furthermore, if Latin America is to receive a substantial inflow of capital in coming years, the challenge is not only to face its macroeconomic and financial stability consequences, but to use them productively to increase the region's growth potential. The experience thus far is not very encouraging.
- In a recent study by the Interamerican Development Bank on productivity gains and losses relative to the United States for a sample of 76 countries, half of the 20 worst performing are from Latin America and the Caribbean. According to the study, a typical Latin American country could have increased income per capita by 54 percent since 1960 if its productivity had grown like that of the rest of the world during the period.
- The document concludes that more than additional investments, countries in the region need to make better use of the existing stock of physical and human capital.