INTRODUCTION

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I don't have to convince you that financial sector liberalization is one of the most critical issues facing policymakers in Latin America. Policies aimed at developing a deeper and wider financial services industry present opportunities for growth and development, but they also present new dilemmas.

Lowering barriers to entry and attracting foreign investment have led to the development of capital markets, but open markets can also lead to increased volatility. In some cases, the resulting weaknesses have resulted in costly bank bailouts and expensive international assistance packages. The challenges faced by policymakers, regulators, and market participants responding to these developments are indeed awesome.

The view from the United States is no less challenging. As the hemisphere becomes increasingly integrated, financial sector liberalization has important implications for U.S. financial markets and the international trade as well.

Even before the events of September 11, this had been an eventful year for emerging markets in general and Latin America in particular. We developed the theme for this conference some time ago, and, given everything that has happened this year, the topic has become even more relevant.

Over the next day and a half this conference will address these important issues, looking closely at where we are, while casting a critical eye to where we may be going. Conference participants will explore a range of policy issues related to the impact of financial sector liberalization on capital flows, the banking sector, and financial markets. The conference will conclude with a roundtable on monetary and regulatory policy featuring four distinguished speakers.

All discussions will focus on reforms to date and current and expected policy options, and we have budgeted ample time for all conference attendees to participate. As you look over the program, you'll see that we have assembled a broad array of experts.

Our presenters, like those of you who came to share in the program, represent four distinct constituencies: policymakers, regulators, academics, and financial market participants. Many of you have participated in more than one of these categories at one time. In bringing these groups together, it is our hope that we can share specific viewpoints and concerns across disciplines.

Our program is divided into four sessions. The first block deals with two big picture issues—capital flows and financial sector liberalization.

In recent history, many Latin nations have taken steps to restructure their economies. Import substitution and capital controls, for example, were largely abandoned in favor of polices that began to open up the region and integrate it into the global economy.

These open policies imparted opportunities for faster growth and held the promise of more rapid development—bringing with it the benefits of poverty reduction, better health and education, and rising quality of life, to name a few.

However, as we saw in Mexico, Brazil, Argentina, and many other episodes, capital inflows can quickly become capital outflows, which can lead to severe economic and financial stress.

While there are large differences in the intensity, nature, and effectiveness of capital account liberalization, it does not come without problems. A recent International Monetary Fund (IMF) study notes that the sharp acceleration in all types of capital flows in the early 1990s was followed by a stalling in terms of foreign direct investment and a sharp decline in portfolio inflows during the later part of the decade.

Importantly, rather than reflecting any change or backtracking in the degree of openness, these later developments are more a reflection of the general global economic and financial scene—the Asian and Russian crises, the Long-Term Capital Management (LTCM) situation, and a general reassessment of risk.

The IMF report also finds that openness to capital flows can lead to a deepening of financial markets and improvements in the allocation of resources. Private credit is a higher proportion of gross domestic product in liberalized economies while stock market turnover is almost triple that in closed economies. At the same time, the cost of openness is greater volatility and financial instability that can be associated with excessive inflows and outflows—instability that can damage growth prospects.

The financial crises I noted a moment ago cast doubts on the ability of such flows to stimulate long-run growth in developing economies. Many studies conclude that the impact of capital flows on long-run growth potential is influenced to a high degree by the policy choices taken by officials, including how quickly countries are relaxing capital controls and how predictable investment policies are.

The premature celebration of the boom in capital flows in the first half of the 1990s has been replaced in recent years by a skepticism that is equally unwarranted. Private capital flows are not likely to solve all development problems and can impose significant costs. However, when harnessed effectively, they can boost investment and spur productivity growth.

Domestic policy priorities that foster more efficient investment will also attract productive foreign capital. Ultimately, domestic strength, including a robust and prudent financial sector, can also protect a country from the volatility induced by capital flows.

Along with opening up capital markets, many Latin American economies liberalized their financial sectors. These moves have led to opportunities for growth as well, but they have exposed some weaknesses that played a role in a number of recent financial crises in the region.

Economic history provides ample support for the idea that financial development makes fundamental contributions to economic growth. Financial development played a critical role in promoting industrialization by facilitating the mobilization of capital for large investments.

Scholars have also argued that well-functioning banks spur technological innovation by identifying and funding those entrepreneurs with the best chances of successfully developing new products and implementing innovative production processes. A large body of evidence suggests that financial development contributes significantly to growth, even after accounting for other growth determinants.

Through its strong effect on overall economic growth, financial development is central to poverty reduction. Recent research also shows that financial development directly benefits the poorer segments of society and that it is associated with improvements in income distribution.

In addition, there is some evidence that suggests measures of financial development are positively and significantly correlated with the share of income of the bottom quintile of the income distribution. Thus, arguments that the development of the formal financial system only benefits the rich do not appear to be supported by the empirical evidence.

The two papers in this afternoon's session will provide some perspective on both the theory and the practice of financial development and capital flows in Latin America.

First, Myriam Quispe-Agnoli and Elizabeth McQuerry offer a new and unique tool for measuring financial sector liberalization. They have constructed an index using a mixture of financial system indicators that allows us to observe macro changes in financial deepening at the country level. And they have come up with some very interesting preliminary results. This paper is a good starting point for us today because it provides a view of financial system development from a broader perspective—somewhat removed from the effects of individual changes or crises.

Also in this afternoon's session, Ugo Panizza will discuss prospects for capital flows to Latin America with an emphasis on what is likely to be different from past experience. He is filling in for Eduardo Fernández-Arias, who had to stay in Washington because of his duties with the Inter-American Development Bank.

Discussing these papers and sharing their own thoughts on these matters will be Jorge Desormeaux and Susan Minushkin.

Following our afternoon session, the president of the Atlanta Fed, Jack Guynn, will introduce our keynote speaker, Ricardo López-Murphy. López-Murphy will offer his firsthand experiences in dealing with the issue of domestic finance in an era of global markets and also share with us his views on the latest developments in Argentina.

When we reconvene tomorrow we will look deeper into financial systems. The latest World Development Report from the World Bank notes that weak institutions—angled laws, corrupt courts, deeply biased credit systems, and elaborate business registration requirements—all hinder development.

The report reads, "Overly complex regulations are especially problematic in poor countries. Rather than protecting consumers and businesses, these regulations lead to higher corruption, a diversion of energy, and lower productivity."

Therefore, how policymakers shape the legal and regulatory environment is key. In particular, shareholder rights, clear property and bankruptcy laws, and efficient contract enforcement mechanisms are essential factors in financial system development.

The World Bank report also states that openness to trade and greater competition contribute to the development of financial institutions, regardless of the country's legal origin, colonial history, or political system. This is an important consideration—something I hope we will touch on again tomorrow—that there are many paths to establish a developed financial system.

All financial systems have several key ingredients, and one is prudential regulation. Official supervisors act as delegated monitors for depositors, working to overcome information problems that would be beyond the resources of individuals. Nevertheless, the recent spate of banking crises—whose severity was exacerbated by international financial linkages—has had severe consequences for growth.

These crises have renewed interest in improving financial regulation through the creation of international standards in bank regulation and supervision. Miguel Kiguel will offer his unique perspective on these issues and on policy lessons and prospects for the region's banking sector, Argentina's in particular.

A family emergency prevents Dr. Kiguel from joining us in Miami, but we have arranged for him to contribute his views via audio conference.

As we all know, a solid supervisory framework—and strict application of regulations—are necessary preconditions for banking sector safety and soundness at all levels. However, while domestic regulations exist along side international guidelines—which are ideally complementary—their functioning is not without friction.

José María Fanelli will explore the implications of a new international financial architecture on existing financial systems in Latin America.

Rogério Studart will then turn our discussion toward the important issue of credit allocation in the wake of banking crises as he examines the factors behind weak or nonexistent credit allocation in Latin banking sectors today. He also looks at the impact of the growing presence of foreign banks on this situation.

Martín Naranjo and Alejandro Werner will then share their thoughts on these issues and the papers presented.

Our third session will more closely examine several financial market questions. John Welch will discuss work he has done regarding the issue of crisis recovery, noting that while some recoveries are the result of sound policy responses, there are examples where policy may not have played a determining role.

Eduardo Walker and Fernando Lefort will then look at the future of domestic capital markets in Latin America. As domestic stock markets are merging into global exchanges, and new electronic forms of trading make smaller emerging stock markets less relevant, the authors examine the implications of this trend for emerging market countries, reporting in particular the impact on economic development.

Arturo Porzecanski and Jerry Dwyer will comment on these papers and share their perspective on these important issues.

Our conference will conclude with a policy roundtable discussion of monetary and regulatory policy choices in an era of global markets. Bob Eisenbeis, the Atlanta Fed's senior vice president and director of research will lead the discussion of our panelists—Nouriel Roubini, Liliana Rojas-Suarez, Ilan Goldfajn, and Leonardo Villar Gómez.

Our panelists have been invited to give opening statements focusing on the session themes and a short series of previously distributed questions focusing on which issues monetary and regulatory policymakers are likely to face in the future and how could they best be handled. As with all of our sessions, there will be a generous time allotment for audience participation and discussion.

And I will also note that we have allotted ample time for informal discussions throughout the conference—time to talk individually with presenters or just time to chat with each other—because this is, as we all know, very valuable as well.

Although the conference was coordinated by the bank's Latin America Research Group, specifically through the hard work and dedication of Elizabeth McQuerry, we have also had the support of a number of people, including the bank's senior management and the research and public affairs departments. We have also benefited from the advice of an number of experts, many of whom are here in this room today.