CEPAL

REVIEW

NUMBER 54
DECEMBER 1994
SANTIAGO, CHILE

ANIBAL PINTO
Director of the Review

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Technical Secretary

UNITED NATIONS

CONTENTS

Liberalization *or financial* development?

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The Latin American countries' reorientation towards market economies and their efforts to open their economies up to the international market since the 1970s have given rise to various sorts of financial policies. This article reviews some selected experiences in three areas of the financial sector: i) in the area of banking, eight different cases are examined in which financial liberalization measures led to various problems in terms of bank solvency during the past 20 years; ii) in respect of the capital market, the rapid development of this market in Chile since the start of the 1980s is analysed; and iii) with regard to inflows of private external financial capital, the high rates exhibited by Mexico since the late 1980s are evaluated. Basing his approach on concepts that place financial liberalization within the context of the types of regulatory systems that establish the ground rules in this sector, the author emphasizes the need to develop the institutional structure of the financial system in a carefully planned manner in order to ensure the solvency and efficiency of financial institutions. Thus, a sharp distinction is made between financial deregulation and controlled financial development.

I

Introduction

Financial liberalization forms a part of the economic policy reforms being carried forward by a growing number of countries since the mid-1970s in an effort to establish open, market-oriented economies.

This article seeks to demonstrate the decisive role played by the institutional structure –i.e., the system of regulations and standards that establish the "ground rules" for financial institutions– in the attraction and allocation of funds by these institutions in the credit and capital markets. In order to substantiate this assertion, a number of experiences with financial reforms or liberalization in the countries of the region are analysed.

There are at least two other factors that also have a strong influence on the part played by financial markets in the capital-formation process. One is the supply of funds, since the role of financial institutions is to attract funds and allocate them to investment and other socially profitable uses. The second is a macroeconomic environment which sends out correct resource-allocation signals to financial institutions and economic agents, primarily in the form of a real exchange rate and real interest rates that are in line with medium- and long-term conditions. In the following discussion, these factors are regarded as forming part of the overall environment within which financial reforms or liberalization measures are adopted.

The article first addresses a number of conceptual questions, placing financial liberalization within the context of the types of regulations to which financial institutions are subject (section II) and outlining some alternative systems for the prudential regulation and supervision of the banking sector (section III). Some noteworthy experiences relating to the role of the institutional structure in the credit and capital markets of the countries of the region are then reviewed. The significance of flaws in the system of regulation and supervision of the banking sector is illustrated through an analysis of a sample group of countries in which financial liberalization measures have created problems in terms of institutional solvency during the past 20 years (section IV). The 1981 reform of Chile's pension system based on the capitalization of pension funds is examined as an outstanding example of an effort to stimulate the capital market's growth through forced saving and vigorous institution-building (section V). The article also explores the development of Mexico's capital market since the late 1980s on the basis of domestic financial reforms and the planned introduction of an array of bonds and other securities which, together with strong incentives for foreign portfolio investment, have made Mexico the leading destination for external funds in the region (section VI). Finally, a number of conclusions are presented (section VII).

II

Types of regulations applying to financial institutions

There are basically three types of regulations which, in combination with one another, dictate the ground rules for financial institutions and agents involved in credit and capital markets: financial regulations, regulations governing the way in which the finance "industry" is organized, and prudential regulations designed to safeguard such institutions' financial stability.

1. Financial regulation

Financial regulations are designed to contribute to macroeconomic stability and secure more efficient resource allocation to production and capital formation through the maintenance of positive (but moderate) real interest rates and a realistic, credible exchange rate.

TABLE 1

Latin America: Regulation of financial institutions

Type of regulation	Main objectives	Deregulation policies	Policies for reinforcing regulation
Financial	Efficiency in resource allocation Macroeconomic stability	Financial liberalization: broadening of financial markets' role in attracting and allocating funds	The role of financial markets is restricted Intervention may lead to financial repression
Organizational	Financial-institution operating efficiency	Organizational deregulation: the range of financial services which financial institutions may offer is broadened	The range of financial services which financial institutions may offer is reduced
	Financial-market efficiency	Institution-building: new financial instruments and institutions are introduced	Specialized financial institutions are created
Prudential	Solvency of financial institutions	Prudential deregulation: rules governing the solvency of financial institutions are relaxed The absence of prudential regulations leads to the "decontrol" of solvency	Rules governing the solvency of financial institutions are strengthened

Financial regulations influence interest and exchange rates by officially setting them, by establishing bands or ceilings, or by permitting the monetary authority to participate in the money and foreign-exchange markets. Such regulations may also establish restrictions, reserve requirements and taxes on foreign investors' access to domestic financial markets and on national financial institutions' access to third-party funds, whether in local or foreign currency, thereby influencing these key financial prices.

Primarily with a view to enhancing the financial system's efficiency, financial deregulation seeks to broaden the market's range of action in determining interest and exchange rates and to reduce the restrictions on the attraction and allocation of funds, including credit. Seen from this vantage point, financial liberalization is a wide-ranging policy of deregulation which is generally one of the components of broader market-economy reforms. In contrast, the tightening of financial regulations typically involves measures by the authorities to limit the action of the market.[1] When, in taking such measures, the authorities set interest or exchange rates too low or establish high reserve requirements and harsh restrictions on the attraction of funds, a situation of "financial repression" is created.[2]

[1] Regulations are sometimes tightened in order to preserve macroeconomic stability; at other times, such a step is prompted by movements of funds that may cause interest rates or the exchange rate to veer away from their medium- and long-term equilibrium levels.

[2] "Financial repression" reduces the volume and real growth rate of funds and results in a backward type of financial system composed of a handful of oligopolistic banks.

2. Organizational regulation

The regulations governing the way in which the finance "industry" is organized are chiefly aimed at increasing the efficiency of financial institutions and of the credit and capital markets.

In order to boost financial institutions' operating efficiency,[3] these types of regulations should allow such firms to make full use of their installed capacity, available economies of scale and the cost advantages afforded by the provision of complementary financial services; at the same time, they should encourage competition by reducing entry barriers to the various segments of the credit and capital markets.

In order for financial markets to be efficient, these regulations should promote full disclosure of the financial standing of participating agents (this subject will be explored further in the discussion on prudential regulations), should avert conflicts of interest among them arising out of zero-sum transactions which increase one agent's assets at the expense of others (through, for example, the use of inside information or information that is not available to the

[3] Operating efficiency is denoted by a minimal spread between the rates on loans and deposits in the case of banks and other financial intermediaries that operate as lending institutions and by minimal commissions in the case of institutions and agents offering financial services.

general public[4]), and should permit the entry of new financial instruments and institutions to an extent commensurate with the amount of funds channeled through the credit and capital markets.

Within this context, the aim of organizational deregulation is to broaden the range of financial services which financial institutions can offer, thus bringing into play the advantages of diversification and the trend towards de-specialization to be observed in today's financial markets. One typical example is that of specialized commercial banks that have expanded their business activities and become full-service banks ("multibanks") or even universal banks offering the entire gamut of financial services. When organizational regulations are tightened, on the other hand, the range of services that financial institutions may offer is restricted as a means of inducing them to specialize (for example, as savings and loan institutions or agricultural banks).

3. Prudential regulation

Financial institutions manage a huge volume of other people's funds, assuming varying degrees of risk in the process, or they may put financial investors in contact with companies in the real sector of the economy which issue listed stock in order to obtain medium- and long-term financing. These institutions' ability to perform these functions is founded upon public confidence, and their solvency (i.e., their ability to service their debts and obligations with third parties under pre-arranged terms and conditions) therefore has very substantial macroeconomic externalities.[5] Hence, the prime objective of prudential regulations is to maintain the solvency or financial stability of these institutions.

To this end (and in order to enhance the efficiency of financial markets), prudential regulations work in two main ways. First, they seek to ensure transparency with regard to the solvency of financial institutions and stock companies by requiring them to provide full, accurate information on a timely basis regarding their exposure, financial performance, assets and other matters that have a bearing on their ability to meet their payments under the agreed terms and conditions on any bonds or other securities they may have issued. This type of disclosure enables financial investors (depositors, savers, etc.) to arrive at informed decisions based on the yield, level of risk and liquidity of the various bonds and other securities offered on financial markets. Second, they seek to maintain financial institutions' stock of assets or capital at adequate levels by requiring the measurement of their exposure, full loss provisioning (through the use of profits to establish the corresponding reserves) and the prompt replenishment of capital in the event of unexpected losses (due to macroeconomic disturbances or other events that generate system-wide risk). This provides incentives for financial institutions to make sure, on their own initiative, that their level of exposure is in keeping with the size of their capital reserves.

In this context, deregulation involves the relaxation of controls designed to safeguard financial institutions' solvency. If this process is carried too far, it results in "decontrol", i.e., a conspicuous lack of disclosure requirements and of limitations on the level of risk which financial institutions are permitted to assume. The reinforcement of prudential regulations, on the other hand, refines or strengthens provisions designed to maintain the solvency of financial institutions and encourages depositors, savers and financial investors to play an active part in controlling the level of risk that can be assumed by financial institutions and stock companies, in order to prevent the loss of the funds they have put into those firms.

4. Supervision

Effective supervision of financial institutions is essential in order to ensure their compliance with the financial, organizational and prudential regulations to which they are subject. Depending on the stage of maturity reached by the relevant credit and capital markets and the policy being used to further their development, such supervision may involve one or more specialized authorities in the public sector.

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[4] The following are some examples of conflicts of interest: the granting of high-risk loans by banks to their proprietors ("related-party" loans), the subsequent settlement of which entails a loss of deposits; a bank's expansion of its operations to include the management of third-party funds which it then uses for its own benefit at low interest rates, to the detriment of the parties supplying the funds; and situations where banks are allowed to hold stock in production firms as part of their assets and, by using the inside information contained in the corporate loan and project portfolios to which they have access, are in a position to make an unfair profit in the stock market.

[5] A failure on the part of banks or other financial institutions to pay out deposits or discharge other obligations may trigger a large-scale run on their resources, a loss of confidence in the financial system and a decrease in credit and other financial claims. In contrast, the perceived solvency of financial institutions gives solidity to the payments system, reduces financial institutions' transaction costs and permits the attraction of domestic and external funds that would otherwise not be made available.

How well these agencies do their job will be determined primarily by their degree of autonomy, their powers of enforcement and the amount of governmental backing they enjoy, by the extent of their supply of highly skilled personnel (to ensure that regulations and their enforcement are based on sound technical grounds), and by the establishment of clear-cut regulations and carefully calibrated penalties in the event of non-compliance.

Within this context, the central components of the prudential supervision of financial institutions are the regular monitoring of these institutions to ensure that their portfolios (of loans or financial investments, as the case may be) have been correctly appraised on the basis of their varying degrees of exposure and, on that basis, the publication of simple solvency indicators that are readily understandable by depositors and financial investors.

III

Prudential regulation and supervision of the banking system

In view of the financial fragility of the banking system, the regulatory and supervisory apparatus that safeguards its solvency are of prime importance. This fragility is a result of two of the characteristic features of banks. The first is the highly leveraged nature of their financial structures: their financial liabilities (deposits plus other obligations) or their financial claims (loans and financial investments) are customarily equivalent to more than ten times their capital. Second, banks receive resources from third parties and then loan out those funds in their own name and, in so doing, assume various levels of risk which they cover with their own capital and other assets. Consequently, the loss or decline in value of even a fraction of their loan and investment portfolios may seriously jeopardize their solvency.

1. Regulatory safeguards for the banking system's solvency

A prudential regulatory system for the banking sector includes the following components:

(a) *Banking-system entry requirements:*

(i) The minimum amount of capital necessary for incorporation;

(ii) Qualifications required of principal shareholders, directors and chief executive officers.

(b) *Levels of exposure in keeping with banks' highly leveraged financial structures:*

(i) Widely diversified loan and investment portfolios, and restrictions on "related-party lending";

(ii) Limits on excessive imbalances between assets and liabilities.

(c) *Full loss provisioning by banks:*

(i) Careful measurement of exposure;

(ii) Immediate establishment of reserves to cover all risks.

(d) *Maintenance of bank capital on a sound footing:*

(i) Suspension of interest on high-risk loans;

(ii) Prompt replenishment of capital following unprovisioned losses;

(iii) Capital requirements in line with asset risk.

(e) *Transparency in respect of banks' financial status: provision of information (presented in the form of easily-understood indicators) to depositors on a regular basis regarding banks' exposure and assets.*

(f) *Mechanisms for orderly exiting from the banking system:*

(i) Insolvency of a bank and liquidation proceedings;

(ii) Establishment of the order in which payments on deposits and other obligations must be made out of the bank's remaining assets.

The effectiveness of these standards and regulations will depend on the effectiveness of their enforcement, the regular publication of indicators of bank solvency, and full awareness by depositors and investors that they may lose their funds in the event of bank financial problems.

If transparency in respect of the banks' financial position is not maintained, depositors and investors will be unable to bring "market discipline" to bear on these institutions by choosing banks on the basis of the interest rates they offer on deposits and the level of risk associated with their assets. At the same time, insufficient transparency will foster the idea among depositors and investors that their funds are covered by some sort of "implicit" government guarantee or, in other words, that the public sector will cover their losses in the event of a bank failure even if no written guarantee to that effect exists. Naturally, if deposits and other obligations are in fact covered by an explicit guarantee or form of insurance, then the extent of depositors' and investors' control over a bank's solvency will be limited in direct relation to the proportion of such funds thus covered.

2. Alternative systems of prudential regulation and supervision

The above-mentioned safeguards of bank solvency and insurance or guarantees of deposits are the two main components of an institutional system or mechanism for regulating and supervising banks to ensure their financial soundness. The different possible combinations of these two components yield four types of alternative systems (see table 2): a completely free or unregulated banking system, a banking system controlled by the public sector, a dual-control banking system, and a decontrolled system or one which has no solvency safeguards.

(a) *Free or unregulated banking systems*

In a free or unregulated banking system, there are no government guarantees or deposit insurance, nor are there regulations to ensure bank solvency, or any other regulations, for that matter. Inasmuch as depositors have to assume a high degree of risk, they will demand full disclosure regarding the banks' financial standing and will take great care in choosing a financial institution or may be willing to make deposits only at very high real interest rates.

(b) *Banking systems controlled by the public sector*

The existence of explicit or implicit State guarantees or insurance on deposits and other obligations eliminates the need to weight profit/risk considerations against each other, by inducing depositors and investors to make funds available to banks without taking into account the risk of bank failure. Under these conditions, the primary, if not the only, motivation of depositors and investors is to determine which banks are offering the highest interest rates on deposits. Consequently, the responsibility for ensuring bank solvency rests entirely with the public sector's arrangements for prudential regulation and supervision of the system. Carrying out this task will demand very precise definition of the above-mentioned safeguards and stringent enforcement of them.

(c) *Dual-control banking systems*

The absence of any explicit guarantees or insurance on deposits and other obligations, when combined with regular reporting on banks' financial standing, encourages depositors and financial investors –especially those dealing in large sums of money– to play an active part in bringing the discipline of the market to bear on the system. They will gauge the level of risk affecting the banks' assets (since this risk also extends to their own funds) and will weigh this against the interest rates being offered on deposits. At the same time, under these systems the authorities enact prudential regulations and supervisory measures will limit bank exposure and will establish requirements in regard to loan-loss reserves and capital. Since in this case both the agents supplying funds and the public authorities are taking steps to ensure bank solvency, the system can be described as being based on a dual-control institutional structure.

(d) *Decontrolled banking systems or systems having no solvency safeguards*

In this case, broad explicit or implicit government guarantees on deposits and other obligations induce depositors and other bank creditors to make funds available to banks solely on the basis of the interest rates they are offering on deposits, with no consideration being given to their risk of failure. At the same time, prudential regulation and supervision exhibit serious shortcomings or are virtually nonexistent, and banking regulations and supervision are limited to the observance and enforcement of accounting procedures and financial regulations. In these circumstances, neither depositors and other bank creditors nor any government authorities are concerned with the banks' exposure, and safeguards for bank solvency are therefore lacking under this type of institutional arrangement.

TABLE 2

Systems for regulating and supervising bank solvency

Solvency regulations / Guarantees on deposits and other obligations [a]	Without solvency controls	With solvency controls
Without guarantees on deposits	Free or unregulated banking system: [b]	Dual control of banking system:
	Banks are subject to control by depositors	Banks are subject to control by depositors and government financial regulators
With guaranttees on deposits	Decontrolled banking system:	Banking system controlled by public sector:
	Banks are not subject to control by depositors or government financial regulators	Banks are subject to control by government financial regulators

Source: Adapted from Feller (1989).

[a] The table is based on the assumption that, if deposit insurance does exist, premiums are uniform and the insurance therefore has effects similar to those of a partial guarantee on deposits (depositors tend to focus their attention on interest rates and to ignore the level of risk to which their deposits are subject).

[b] Strictly speaking, a "free" banking system would exist only in the absence of any sort of regulation whatsoever, rather than simply a lack of prudential regulations.

IV

Problems of insolvency registered in the course of financial liberalization programmes in the region

1. Shortcomings in prudential regulation and supervision as a factor in a banking system's financial instability

Table 3 lists eight financial liberalization programmes which led to problems in regard to bank solvency in the past 20 years. Two factors played an especially important role in this respect. First, the systems' prudential regulation and supervisory apparatus suffered from serious shortcomings due to defects in the system for controlling risks, inadequate regulations concerning reserves and capital, feeble supervision or supervision limited to accounting procedures and financial aspects, and the presence of explicit or implicit government guarantees on deposits and other obligations. Almost all of these problems arose in systems having precisely the type of institutional structure most likely to generate problems of insolvency: i.e., decontrolled banking systems or systems lacking solvency safeguards (see table 2).

Second, in many of these cases the macroeconomic environment generated high levels of systemic risk owing to unstable conditions or the impact of radical adjustments that gave rise to major changes in the levels of economic activity, relative prices, and corporate and personal income. By affecting the "primary" source of loan payments or the value of guarantees (the "secondary" source of payment), these factors themselves reduced the quality of the banks' loan portfolios (see the annex for a summary of these liberalization experiences).

2. Recent reforms in bank regulation

The instances of financial instability seen in the region over the past 20 years (including those listed in table 3) and the spread of financial liberalization and reform policies have led to a generalized tendency to strengthen prudential regulation and supervision of the banking system, particularly since the mid-1980s.

TABLE 3

TABLE 3

Latin America (8 countries): Problems with bank solvency in the past 20 years

Country	Period	Financial regulation	Macroeconomic conditions	Prudential regulation and supervision	Results	
					Stability of financial system	Financial prices
Argentina	1974-1981	Liberalization of interest rates and credit; early opening of capital account	Fiscal deficit and high inflation; stabilization based on exchange rate (1978-1981)	Serious shortcomings	Financial crisis in banking system	High real interest rates; exchange-rate lags
Chile	1974-1982	Liberalization of interest rates and credit	Structural reforms and financial adjustment of public sector; stabilization based on exchange rate (1978-1982)	Serious shortcomings	Widespread banking crisis	High real interest rates; exchange-rate lags
Uruguay	1974-1982	Liberalization of interest rates and credit; early opening of capital account	Trade deficit; stabilization based on exchange rate (1979-1982)	Serious shortcomings	Financial crisis in banking system	High real interest rates; exchange-rate lags
Colombia	1979-1982	Sectoral credit limits; cautious management of external debt	Relatively stable	Serious shortcomings	Financial crisis in banking system	Fragmented interest rate structure
Costa Rica	1983-1987	Gradual liberalization of interest rates and credit	Stabilization and adjustment of balance of payments	Substantial improvements in prudential regulation and supervision	Financial crisis in unregulated finance houses	High real interest rates; in unregulated financial sector
Bolivia	1985-1990	Liberalization of interest rates and credit	Stabilization and structural adjustment following large fiscal deficits and hyperinflation	Serious shortcomings	Isolated cases of bank failures	Decline in very high levels of real interest rates
Peru	1990-1992	Liberalization of interest rates and credit	Stabilization and structural adjustment following large fiscal deficits and hyperinflation	Flaws in regulations on loan-loss reserves and capital	Problems with bank solvency	Slow decline in very high levels of real interest rates
Venezuela	1989-1994	Liberalization of interest rates and credit	Stabilization and adjustment in the presence of public-sector deficit	Serious shortcomings	Financial crisis in banking system	High real interest rates

The reforms made in these regulatory systems have emphasized solvency safeguards and the role of supervisory authorities, together with the importance of defining and limiting government guarantees or deposit insurance. The first course of action has led to a restriction of portfolio risk, especially in connection with related-party loans, and to the rating of loan portfolios on the basis of the debtors' risk categories, as well as to the establishment of stricter loan-loss reserve requirements and, increasingly, to the practice of setting capital requirements according to the level of risk associated with different categories of assets, in keeping with the recommendations set forth in the Basle Accord. [6] As regards the second course of action, most of the countries have chosen to establish explicit but limited guarantees on deposits, while a few have decided to dispense with this sort of protection. [7]

Little progress has been made, however, in improving the provision of information to depositors and the general public regarding the risk involved in bank investments and credit. This has tended to sustain the belief that there is an implicit governmental guarantee on deposits, even though in fact limits have been placed on such guarantees. Even in Chile, –where, since 1987, relatively simple indicators of these risks and of the financial position of banks have been published and where depositors have been warned of the risk of losing part of their money, since government guarantees are limited to certain amounts– a considerable percentage of depositors continue to behave as if their funds were actually covered by some sort of implicit guarantee (Valdés and Lomakin, 1988). So long as this belief persists, the responsibility for regulating and supervising the banking system's solvency will continue to be shouldered primarily by the public authorities (see table 2).

The organizational reforms carried out over the past 20 years have often included authorization of the expansion of commercial banks' business activities so that they can become multibanks or even, as occurred in Mexico, universal banks through the establishment of corresponding regulations on financial conglomerates (see section VI). Meanwhile, in those countries of the region which already have fairly well-developed financial systems, there has been a tendency towards the formation of *de facto* financial conglomerates, through the interrelated ownership and management of banks and other financial institutions. This process has raised a number of complex issues in relation to organizational and prudential regulatory systems' effectiveness in achieving the objective of transparency with regard to reporting on the performance and financial status of the relevant institutions and of the conglomerate to which they belong and in forestalling conflicts of interest which may benefit some member firms of the conglomerate at the expense of other economic agents (Morandé and Sánchez, 1992).

V

Pension system reform and development of the capital market in Chile

At the end of 1980, the Chilean authorities chose to replace the existing shared-benefit pension system with an individually funded pension scheme. Payments into the system are mandatory for all persons receiving salaries or wages, and these compulsory payments are made by the employees themselves in the form of a 10% deduction from their earnings (subject to a ceiling, above which the individual may voluntarily make payments in excess of that level). Thus, this new pension system is based on an institutionally-organized form of forced saving.

[6] In order to determine a bank's capital requirements, the Basle Accord assigns a weighting, from 0% to 100%, to various types of assets in the light of the level of credit risk involved. For example, funds on hand carry a weighting of zero while credits are assigned a weighting of 1. In order to bring the capital requirements of banks in different countries in line with one another, the ratio between their capital and the various categories of risk-weighted assets was to amount to 8% by the end of 1992.

[7] National Banking Commission of Mexico, report on the results of a survey on deposit insurance presented at the tenth assembly of the Association of Banking Supervisory Organizations of Latin America and the Caribbean (Santiago, Chile, 1993).

These newly-established pension funds have quickly become the nation's leading institutional investors and have played a pivotal role in the swift development of Chile's capital market.[8] As of late 1992 –one decade after they had entered into operation– pension funds had amassed the equivalent of 34.5% of GDP (while insurance companies, mutual funds and foreign investment funds possessed resources equivalent to 9.2%, 2.6% and 3% of GDP, respectively). As of that date, pension funds held approximately 60% of the securities issued by large firms, around 60% of the mortgage bonds in circulation, and over 20% of the shares which they were eligible to purchase. The growing presence of these pension funds is illustrated by the projections which indicate that these funds' resources are expected to equal the country's GDP by 2015-2020 (Iglesias, Acuña and Villagrán, 1988).

1. Institution-building in the capital market

Because of the rapid growth of Chile's pension funds, its capital market needs a sturdy institutional structure capable of channeling those resources towards socially profitable uses via an array of financial institutions and instruments that are subject to a prudential regulatory system. Institution-building efforts are felt to have played a decisive role in the achievements of the new pension system to date (regarded as being confined, for our purposes here, to the accumulation of funds and savings) and in its consolidation over time (Arrau, 1993).

Table 4 outlines the institution-building process that has taken place in the securities and insurance market since the end of 1980, when the laws were promulgated which created Chile's new pension system and its basic institutions: pension funds, pension-fund management firms (AFPs) and the superintendency that is in charge of regulating and supervising the latter (the SAFP). The table shows that the country's financial authorities have made an ongoing effort to update and refine the regulations and standards applying to various aspects of the burgeoning capital market (open-ended corporations, securities trading, market transparency, the rating of listed securities, gradual expansion of investment options for pension funds, redefinition of the role to be played by the Superintendency of Securities and Insurance, etc.).

A bill is currently under consideration by Congress that would make major changes in the regulations applying to the capital market (see table 4) in view of the concentration of pension-fund investments in the stocks of public utilities and the present shortage of financial instruments. Yet new needs for institutional regulation are already in the offing in such areas as overseas investments by pension funds, the further development of the life insurance industry (which pays out pensions in the form of annuities) and the regulation of financial conglomerates as banks expand their activities and move into various segments of the credit and capital markets.

Pension funds and their management firms (AFPs) are subject to extremely stringent prudential regulations and supervision because of the fact that they are made up of workers' forced savings (which will be those workers' main source of income after they retire) (see table 5). The equity capital of the AFPs is completely separate from that of the pension funds; an AFP may administer only one fund at a time and must guarantee a minimum return on the assets it manages. The statutes governing the funds' portfolios stipulate that all bonds and securities must meet rigorous risk-evaluation standards and must carry high ratings; these portfolios must also be widely diversified in terms of both financial instruments and issuers, and the bonds and other securities they contain are subject to an ongoing appraisal at market prices and must be held in safe-keeping by the Central Bank.

2. Pension reform and national saving

The savings generated by the reform of the pension system have also made a large direct contribution to national savings, although the net effect on the latter is difficult to ascertain due to substitution of or complementarity with other forms of saving. We do know, however, that gross national saving (at current prices) jumped by 11 points from a pre-reform average of 12.5% of GDP in 1976-1979 to an average level of 23.5% in 1990-1992. Pension-based saving directly accounted for slightly more than three points of GDP in that substantial increase.[9]

[8] Their position in this respect is due both to the long payment periods that elapse between the time when an individual enters and withdraws from the workforce (usually between 30 and 40 years) and to the capitalization of those funds throughout that period.

[9] According to data from the national accounts and the Ministry of Finance of Chile.

TABLE 4

Chile: Development of institutional and regulatory apparatus for pension funds and the stock market [a]

Nov. 1980	D.L. 3.500	Creates private pension systems which include pension-fund management firms (AFPs) and the Superintendency for Pension-Fund Management Firms (SAFP)
Dec. 1980	D.L. 3.538	Basic Act for the Superintendency of Securities and Insurance (SVS)
Oct. 1981	Act 18.045	Stock Market Act
Oct. 1981	Act 18.046	Companies Act
Dec. 1985	SVS circular 574	Defines "related parties"
Jan. 1986	SVS circular 585	Establishes compulsory disclosure of stock transactions conducted by majority stockholders, directors and executives
March 1986	SVS circular 601	Establishes compulsory disclosure of any event that may significantly affect the business interests of open-end corporations
Oct. 1987	Act 18.660	Requires ongoing rating of stocks on public offer according to their level of risk
July 1989	Act 18.815	Investment Funds Act: permits pension funds to invest in real estate, bearer securities and venture capital
Dec. 1989	Act 18.876	Establishes regulations governing the formation and operation of private securities custodians
May 1992	Rating Commission Agreement	Authorizes AFPs to invest in "greenfield" projects
May 1993	SAFP circular 776	Makes it compulsory to provide standardized information concerning the rate of return on individual accounts according to fund members' income brackets
1993	Bill before Congress	Proposes substantial changes in Stock Market Act: Creates securitization firms Introduces more precise regulations for the rating "industry" Defines responsibilities of bond brokers Creates company development investment funds (FIDEs) Strengthens regulations regarding the solvency of insurance companies Introduces greater flexibility with regard to AFP investment ceilings Regulates risk factors for AFPs' overseas investments

Source: Arrau (1993).

[a] Does not include amendments to the laws and regulations governing the activities of banks and financial corporations or of the Superintendency of Banks and Financial Institutions.

The fact that public saving has been positive since 1987 has played a pivotal role in ensuring that the net effect of pension-based saving on national saving has also been a positive one. This indicates that public finances have absorbed the pension-system deficit that was created when workers' payments were channeled into the new system while the public sector paid the pensions of institutions belonging to the old system (which was plagued with serious financial imbalances of various origins).

TABLE 5

Chile: Prudential regulations applying to pension funds

Contents of regulations
A. *Pension-fund management firms (AFPs)*
1. The assets of an AFP must be entirely separate from those of the corresponding pension fund
2. An AFP may manage one fund only
3. An AFP must ensure a basic minimum rate of return to the fund; in order to do so it shall, if necessary, draw on reserves established by the AFP in question, which are to be held in safe-keeping by the Central Bank.
B. *Pension-fund investment portfolios*
1. Pension funds may invest only in those securities and finacial instruments which are authorized by law
2. Any security or financial instrument in which a pension fund invests must be rated as an acceptable investment by the Rating Commission
3. Strict rules govern the diversification of portfolios by type of financial instrument and issuer with the object of maintaining a low-risk profile
4. As a general rule, all such securities and financial instruments must be traded on a commercial exchange or other established secondary market
5. An appraisal of such investment portfolios is to be conducted as a routine procedure on a daily basis using prices furnished by the Superintendency for Pension-Fund Management Firms (SAFP). At least 85% of the portfolio must be appraised at market prices
6. At least 90% of the securities and instruments making up a pension fund's investment portfolio shall be held in the custody of the Central Bank.

Source: Iglesias and Acuña (1991).

VI

Development of the financial system and the attraction of private external financial capital in Mexico

Two interrelated factors –out of a number of different domestic and external elements– have played a decisive part in attracting private external financial capital to Mexico since 1989: the institution-building and reforms that have taken place in the domestic financial system, and the strong incentives existing for inflows of financial capital.

1. Institution-building and reform in the domestic financial system

The main financial reforms adopted in Mexico since 1989[10] have included the deregulation of credit and interest rates, a far-reaching liberalization of the balance-of-payments capital account, and provisions granting foreign investors access to Mexican financial markets and to stock in non-financial corporations (see table 6).

The liberalization of the financial system was undertaken in conjunction with the banking system's return to private ownership and a broad definition of the activities of multibanks; the adoption of regulations on financial conglomerates headed by a holding company and composed of at least three financial institutions (conglomerates may not hold equity investments in production firms);[11] changes in the

[10] The chief elements that set the stage for this financial reform programme were the nationalization of the banking system in 1982 in response to the external debt crisis, and the rules that allowed foreign agents, within certain limits, to acquire stock in Mexican corporations under the terms of the regulations governing the application of the 1973 legislation designed to promote Mexican investment and regulate foreign investment.

[11] A financial conglomerate must include at least three of the following institutions: a multipurpose bank, a leasing company, a factorage agency, a stockbroking firm, a currency broking firm, a general-purpose bonded warehouse, an insurance company, a bonding company or an investment company.

TABLE 6

Mexico: Reforms implemented in the financial system, 1989-1992

Type of regulation	Principal measures
Financial liberalization	Deregulation of interest rates Elimination of selective controls on credit Elimination of reserve requirements, although the assets of multipurpose banks must be maintained at a predetermined liquidity coefficient Modifications in the regulations applying to foreign investment aimed at facilitating the entry of external financial capital
Organizational development and deregulation	Privatization of the commercial banking system New law governing lending institutions having as their basis private banks established as multipurpose banks Regulation of financial conglomerates based on a system of holding companies Reforms and/or additions and adjustments to the laws governing insurance, bonding and securities markets
Strengthening of prudential regulation and supervision of banks and financial conglomerates	Rating of loan portfolios based on risk category and reserves to cover the level of exposure in question Capital requirement equivalent to 8% of risk-weighted assets (to be met by 1993) Advances in the regulation and supervision of financial conglomerates Advances in the regulation of the overseas operations of Mexican banks

Source: Martínez (1992); Caro (1994).

structure of the securities and insurance markets with a view to their internationalization; and the adoption of new safeguards to ensure the solvency of banks and financial conglomerates (Martínez, 1992).

Nevertheless, the Nacional Financiera, S.N.C (NAFIN) and the Banco de Comercio Exterior, S.N.C. (BANCOMEXT) have continued to operate as public development finance institutions (DFIs) in which second-tier banking represents a substantial component. One of the main functions of NAFIN is to support investment and small-business financing, while BANCOMEXT supplements the financing of export activities of firms of various sizes.

At the same time, the financial authorities introduced a number of domestic securities designed to attract international portfolio investment and authorized the trading of Mexican securities on international capital markets, creating a special section in national securities listings for that purpose. The options for stock transactions thus made available included the sale of shares in Mexican corporations on the United States market via ADRs;[12] the purchase of freely available (series B) shares –shares conferring full pecuniary and equity rights– by foreign investors on the domestic stock exchange; the purchase by such investors of shares that had formerly been reserved for Mexican nationals (series A stock) on the condition that they belong to a mutual fund that grants pecuniary rights (through share certificates) but not equity rights, such as the neutral fund administered by NAFIN; and the establishment of "country funds" (such as the Mexico Fund, which is one of the oldest and largest) through which such investors could acquire shares and other securities on local exchanges.

Foreign investors have also been given access to domestic debt paper through the use of short-term treasury bills denominated in pesos (CETES), adjustable bonds ("Ajustabonos") and other medium-term government securities. Both State and private Mexican firms and banks as well as other public-sector institutions have also been able to secure overseas funds through the sale of bonds, commercial paper and certificates of deposit, primarily in the Euromarket.

2. Incentives for financial capital inflows

Three factors have helped to draw capital to Mexico since 1989: (i) a notable decrease in its country risk and in the exposure of Mexican issuers; (ii) high

[12] ADRs (American Depositary Receipts) are stock certificates issued by a United States bank on foreign-company shares or other securities; these certificates can be traded on the stock market in the United States.

domestic interest rates coupled with low exchange risk (thanks to the pre-established and progressively smaller adjustments being made in the nominal exchange rate with a view to price stabilization), contrasting with low interest rates in the United States and other industrialized countries; and (iii) the marked undervaluation of Mexican stocks in the light of the economic prospects opened up by the reforms under way.

A number of economic policy results played a part in reducing the perceived risk of investing in Mexican securities: the completion of the country's external debt renegotiations in 1989, the country's success in putting its public finances back on a sound footing (transforming the consolidated public sector's deficit, which amounted to 6% of GDP in 1989, into a 1.5% surplus by 1992) and the slowing of inflation, which –as measured by the variation in the consumer price index– fell from 30% to 15% during the same period. In 1992, two well-known international rating agencies put Mexico in a country-risk category that brings offerings of Mexican securities on international capital markets very close to "investment-grade" levels. In the case of securities that are negotiable on the local market, one of those agencies gave Mexico's peso-denominated treasury bills (CETES) the highest possible investment rating for short-term debt paper and rated the Mexican long-term public debt as being of investment grade.

The deregulation of domestic interest rates and bank credit (in the midst of the implementation of stabilization and adjustment policies) opened up a large spread between national and international interest rates. In 1989-1992, the average annual rate for domestic deposits hovered at between 11 and 14 points above short-term annual interest rates in the United States (adjusted for exchange-rate variations in Mexico), and the difference was calculated to have been more than 20 points per year in the case of the average domestic lending rate, owing to the wide spread used by local banks. These differentials –together with a low exchange risk (the nominal exchange rate climbed by 4.3% and 1.4% per year in 1991 and 1992 compared with 18.8% and 11.9% increases in the consumer price index for those years, respectively) and the decreasing risk associated with investments in Mexican securities– generated strong incentives for inflows of external capital through the purchase of domestic debt paper (CETES and others) and overseas sales of securities (bonds and other instruments).

The total value of Mexican corporate stock on the exchange was equivalent to only 11% of GDP in 1989. This undervaluation triggered a large inflow of foreign capital to the stock market, contributing to its subsequent boom. The price index for listed shares leaped by 133% in real terms between 1989 and 1992, while the average annual rate of return, in dollars, on investments in the stock market stood at around 60% during this period (due, in part, to the slow rise in the exchange rate). By late 1992, the value of Mexican corporate stock had risen to nearly 50% of GDP.

Table 7 gives a list of floating- and fixed-rate financial instruments traded in the external and local capital markets, together with the capital flows received during the period 1989-1992 and/or the market value of those funds as of the end of 1992.

3. Macroeconomic effects and regulation of financial capital inflows

Thanks to the exceptionally attractive conditions which Mexico has been able to offer overseas investment, since the late 1980s the country has quickly become one of the region's foremost destinations for external funds. Between 1989 and 1992 the balance on the nation's capital account soared from 1.5% to 7.9% of GDP. Foreign portfolio investment represented 15.5% of this amount in 1989, but by 1992 its share had skyrocketed to 52% (Caro, 1994).

The massive inflow of external financial capital has had macroeconomic impacts that run counter to other economic-policy objectives. The Mexican peso appreciated by 17.6% in real terms between 1989 and 1992, which handicapped the export strategy launched by the country in the 1980s. External saving at current prices (measured as the balance on current account, of reverse sign) climbed by 3.9 points from 2.6% of GDP in 1989 to about 6.5% in 1992. However, gross domestic investment at current prices for that period only rose from 21.4% to 23.3% of GDP: an increase of 1.9%. [13] Thus, national saving at current prices is estimated to have fallen from 18.8% to around 16.8% of GDP during that period, which sug-

[13] Gross domestic investment at constant prices, however, expanded from 17.3% of GDP in 1989 to 21.7% in 1992 –an increase of 4.4% of GDP. The striking difference between the figures for investment at current and constant prices is mainly attributable to the drop in the relative price of capital formation associated with the local currency's steep rise in value and the opening up of the economy to external markets.

TABLE 7

Mexico: Instruments used to attract external financial capital
(In millions of dollars)

Instrument	1989	1990	1991	1992	Gross flows 1989-1992	Value of capital stock at end of 1992
Placements in international market						
Total floating-rate portfolio	-	563	4 404	5 365	10 332	21 773
International share issues (ADRs)	-		4 333	5 077	9 410	21 154
Country funds	-	192	71	-	263	619
Total fixed-rate portfolio	697	2 351	4 074	6 052	13 174	...
Bonds	570	2 351	3 444	4 403	10 767	...
Certificates of deposit	-	-	50	1 050	1 100	...
Commercial paper	127	-	580	600	1 307	...
Placements in domestic market						
Total floating-rate portfolio [a]	-	371	-	2 287	2 658	
Series B shares	-	...	-	...	...	5 100
Series A shares (neutral fund)	-	...	-	...	...	1 800
Total fixed-rate portfolio						
Treasury Certificates (CETES)	-	-	...	...	...	
Floating-rate bonds ("Ajustabonos")	-	-	...	...	...	} 14 400 [b]
Other instruments	-	-	...	...	...	

Source: World Bank, statistics on portfolio investment flows, several years; Gurría (1993).
[a] Direct stock purchase.
[b] Estimate.

gests that external saving was being substituted for national saving, to the extent of about half of the 1992 figure. The wealth effect associated with the revaluation of financial assets (and other non-tradable goods) occasioned by the inflow of capital, along with the resulting increase in aggregate consumption at current prices (3.5 points of GDP) during that period, appears to have played an important part in this outcome.

The above-mentioned macroeconomic effects raise the question of whether it would not be advisable to have financial and prudential regulations designed to curb the inflow of volatile short-term or speculative external financial capital.[14] Advocates of such regulations argue that the incentives for financial capital inflows are excessive and that, in the event of a rapid accumulation of external debt paper, there is a risk that domestic interest rates will be raised in an effort to attract or hold on to these funds. This over-incentive stems from the State guarantee on government securities (CETES and others) and the temporary nature both of low short-term interest rates in the United States (an annual 3.7% in 1992) and of the undervaluation of Mexican stocks.

VII

Conclusions

The financial policy initiatives examined in this article demonstrate that the liberalization of financial variables (interest rates, credit, access to external funds, etc.) is only one of the elements involved in applying market-economy principles to the financial system. There are at least two other types of regulations which –along with the necessary supervision and enforcement– also play a part in laying down the ground rules for financial institutions in credit and capital markets: regulations that shape the organiza-

[14] At the start of 1992 the Banco de México put a cap on banks' external borrowing equivalent to 10% of their liabilities.

tional model of the finance "industry" (primarily with a view to increasing the efficiency of financial institutions and markets), and prudential regulations, which are designed to keep financial institutions and stock companies on an even financial keel.

Financial liberalization can bring about a considerable increase in the volume of funds handled by financial institutions and may expose them to varying risks in a more open environment where they are free to take their own decisions. This type of policy, however, does not of itself establish adequate ground rules as regards the solvency and efficiency of such institutions, owing to the problems concerning disclosure, externalities and conflicts of interest that are characteristic of credit and capital markets. Specific types of financial institutions and instruments do not come into being spontaneously, partly because of the highly regulated nature of financial transactions. This makes it all the more important for the financial authorities to make a systematic, deliberate effort to build up such institutions in order to strengthen the sector's prudential regulation and supervision and to promote the creation of new institutions and instruments or the expansion of existing institutions' operational scope.

The financial crises and difficulties experienced by banks in the region (see table 3) support the assertion that programmes which simply deregulate interest rates, credit and other financial variables without effectively reinforcing the prudential regulatory system are actually instances of financial decontrol rather than the practical expression of a policy of financial liberalization. The behaviour of decontrolled banks, or banks that are not subject to adequate prudential controls, has given rise to financial instability. Apart from this, however, portfolio-related difficulties have also arisen in unstable macroeconomic environments or ones that are undergoing drastic adjustments.

The progress made to date in the prudential regulation and supervision of the banking system in the countries of the region has mainly taken the form of the implementation by specialized public-sector authorities of rules and standards designed to maintain that system's solvency. Thus far, however, the flow of information to depositors and the general public regarding asset risk and banks' financial standing has been very meagre indeed. This has helped to perpetuate the idea that deposits and other obligations are covered by an implicit government guarantee, even though explicit guarantees may have been officially withdrawn or limited. Moreover, not even proper, timely disclosure –as in the case of Chile, for example– seems to have altered this impression for many depositors. It is therefore important for the countries to continue their efforts to improve and refine the regulations that limit and control banks' exposure, especially in cases where financial reforms are allowing them to expand the scope of their activities.

Chile's 1981 reform of its pension system constitutes an outstanding example of a controlled process of financial development as opposed to mere financial liberalization. This reform entails forced institutional saving, strict regulations governing the organization of the pension "industry" as such, and close prudential supervision and regulation of pension-fund portfolios. It is this combination of factors, in large measure, which has permitted the build-up of funds and the development of the capital market observed to date. Institution-building –including that of the relevant public regulatory and supervisory agencies– has played an essential role in this regard. Indeed, this type of institutional development is what has made it possible to continue broadening the spectrum of profitable, safe and liquid investment options open to pension funds so that the rapid build-up of resources may be channeled towards real capital formation and other socially profitable uses. Institution-building is regarded as being of pivotal importance in consolidating the new pension system over time since –within a regulatory framework that greatly limits the level of risk associated with the bonds and other securities eligible for inclusion in pension-fund portfolios– the management firms handling these funds compete freely with one another to achieve the best financial performance and to attract members.

The case of Chile's pension-system reform can be highly instructive for financial policy-makers in developing countries because it is based on an approach that offers an alternative to financial liberalization. This reform underscores the importance of having sufficient savings or funds as well as the need for financial authorities to make a deliberate effort to "develop" the financial market and to provide for stringent regulations and close supervision to ensure that financial institutions properly perform their role in capital formation processes; at the same time, it also points up the limitations of policies that are confined to the liberalization of interest rates, credit and other financial variables, since they simply liberalize what already exists while introducing a high degree of risk as regards the subsequent misuse of funds.

The influx of external capital into Mexico in the form of international portfolio investment since 1989 also provides an excellent example of broad-based institution-building in a domestic financial system. The country's financial reform process has been far-reaching, the financial authorities have introduced a whole array of instruments for overseas investors, and the way has been paved for the sale of Mexican securities on international capital markets. It is also true, however, that this incoming stream of private external capital has occurred in response to excessive incentives for financial capital (generated mainly by the guarantee provided by the State on government securities, by low short-term interest rates in the United States and by the low domestic level of exchange risk). All these factors soon pushed foreign portfolio investment up to extremely high levels. This has raised the question of the advisability of establishing prudential and financial regulations to stem the inflow of volatile, short-term or speculative external financial capital in order to forestall any adverse macroeconomic impacts on the real exchange rate and national saving and to make more room for medium- and long-term external financial flows.

(Original: Spanish)

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ANNEX

Financial liberalization and problems with regard to solvency in Latin America

In the mid-1970s Argentina, Chile and Uruguay began to liberalize interest rates, credit and other financial variables, as well as adopting policies that provided for a broader definition of the activities that banks could perform or the financial services they could offer. These measures were implemented at a time of highly adverse conditions in terms of the financial institutions' continued solvency. The simultaneous application of ambitious stabilization measures –particularly the adoption, in 1978, of the nominal exchange rate as an anchor to stabilize the currency in these three countries– and of reforms designed to open up trade and the capital account led to inconsistencies in economic policy and macroeconomic instability. Overly low exchange rates, high real interest rates and major shifts in the profitability of various economic activities undermined the quality of the banks' loan portfolios.

The programmes for the financial liberalization of the banking system in these countries during the 1970s also failed to provide proper safeguards for these institutions' solvency; explicit or implicit government guarantees on deposits and other obligations were prevalent, and both the standards used for limiting risk and reserve requirements suffered from serious shortcomings. In Uruguay, there were no "minimum" rules; in Chile, loan portfolios did not begin to be rated on the basis of their level of risk until the early 1980s, just before many banks' financial problems surfaced; in Argentina, the banking system operated with virtually no supervision, and the rating of bank portfolios was not initiated until after the Government stepped in during the early 1980s (Banda, 1990; Held and Szalachman, 1989; Salama, 1991). In all three countries, the liberalization of credit and interest rates sparked a sharp rise in high-risk lending at rates from three to five times higher than the growth rate of GDP. These loans included: credit extended to non-tradable activities (including real estate and speculative operations) which was financed in large part with external debt; widespread rollovers of bad debts, whereby interest was compounded at high real rates (producing income that was never actually paid); and excessive credit to related-party companies or individuals for which very little real collateral was put up. Implicit government guarantees on deposits facilitated the domestic and external borrowing by the banks which sustained this process.

It is difficult to determine how far macroeconomic imbalances or the shortcomings of prudential regulatory and supervisory systems had to do with the far-reaching financial crises that erupted in these countries during the early 1980s. It is clear, however, that the second factor did play a major role. It is significant that in both Argentina and Chile and, in part, in Uruguay as well, the banking system's serious financial problems surfaced before the balance-of-payments and external debt crises of 1982-1983 had brought about sharp downturns in these countries' levels of economic activity.

The crisis that hit Colombian banking in the early 1980s illustrates how a system whose financial standing is not subject to any controls can, within a context of financial liberalization, assume a high level of credit risk and unsustainable portfolio losses even in a fairly stable macroeconomic environment and despite a conservative policy on external borrowing by banks. In 1980-1981, bank loans jumped by over 40% in real terms. Following the widespread intervention in the banking sector that began in 1982, it became clear that high-risk related-party loans to conglomerates –including the use of bank credit to buy stock in firms in the production sector– had accounted for a substantial part of the abnormal increase in lending activity. Credit limits and standards had been greatly exceeded, and the sector's supervisory authority had lagged far behind in checking the quality of loan portfolios (Zuleta, 1990).

Costa Rica embarked upon a stabilization and economic reform effort in 1983 following a severe balance-of-payments crisis and its declaration in 1981 of a moratorium on external debt payments. Financial reforms broadened the private banking system's role in credit allocation and deregulated interest rates in a three-stage process aimed at achieving positive yet moderate real interest rates in the supervised banking system. Headway was also made in the area of prudential regulation and supervision through the use of a system for rating the level of risk associated with banks' loan portfolios, the establishment of stricter standards for provisions and the introduction of a set of bank performance indicators as a means of furnishing information to depositors and the general public. At the same time, however, the door was left open for "free" or unregulated financial companies. These institutions quickly increased in number and began to operate in higher-risk segments of the market at high real interest rates. The adoption of a tight monetary policy in late 1987 led to a liquidity crunch in the financial system and to the bankruptcy of all of the unregulated financial companies in existence. Not a single supervised bank failed during this financial disaster, however (De Paula, 1990; Díaz, 1991).

Bolivia and Peru (in 1985 and 1990, respectively) liberalized interest rates and credit in the midst of a situation marked by severe inflationary turbulence and harsh stabilization policies and economic reforms. Real interest rates on loans were extremely high –even after several years had passed, they were still around 40% annually– and both relative prices and the profitability of economic activities fluctuated sharply as the economy was rapidly opened up and steep adjustments were made in aggregate expenditure. These factors were apparently what triggered the banking system's financial troubles in both countries, but flaws in the regulatory and supervisory provisions for safeguarding the system's solvency also played a part. In Bolivia, the closure of four banks in 1987 brought to light the lack of adequate controls on solvency: the limits on exposure were faulty, there was too much related-party lending, supervision was weak and there were implicit government guarantees on deposits. In Peru, the failure of a number of banks and mutual funds starting in 1991 depleted the deposit insurance fund, and the State had to make up the difference; in March 1993, overdue loans represented 22% of the commercial banks' loan portfolios but their loan-loss provisions totalled only 12%, which pointed up the insufficiency of reserves and the presence of lags in bank recapitalization (Afcha de la Parra, 1990; González Arrieta, 1992).

In Venezuela, the authorities' intervention in a commercial bank in February 1994 marked the start of a financial crisis in the banking system. Midway through the year, eight more banks became subject to government intervention; these banks had received financial assistance in the preceding months and together had about 50 subsidiaries, almost all of which were financial institutions. Serious shortcomings in the regulation and supervision of the financial system appear to have been what set off this crisis. The Superintendency of Banks and the Deposit Guarantee Fund (FOGADE) have been given very little operational autonomy, narrow terms of reference and insufficient regulatory powers to deal with difficult financial situations; their control over financial institutions' solvency has been faulty, and a clear separation between their functions has been lacking. In its rating of loan portfolios, the Superintendency has not given enough weight to the risk represented by projected losses or, in particular, to the consolidated analysis of related-party loans made to companies belonging to the same economic group as the lending bank or of the concentration of loans in groups of firms that act as de facto conglomerates in the financial market. For the above reasons, delays arose in the establishment of reserves to cover these risks. In the case of FOGADE, the premiums or contributions which the banks have paid into the Fund have not been differentiated by level of risk, and the Fund's existence appears to have prompted a lack of concern on the part of depositors about their banks' financial standing (Hausmann, Jaramillo and Rigobón, 1992).

The macroeconomic situation also played a role in the Venezuelan banking crisis. The stabilization and adjustment policy introduced in 1989 did not strengthen the public sector's financial status, and indeed, the non-financial public sector's deficit amounted to nearly 6% of GDP in 1992-1993, which, given the country's tight monetary policy, pushed interest rates to high levels. In 1993, real rates on loans were around 30% and themselves led to a deterioration in the quality of bank loan portfolios.