

# Reflections

*on development*

## financing

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**Roberto Frenkel**

*Senior Researcher,  
Centro de Estudios de Estado  
y Sociedad (CEDES)  
Director,  
Banco de la Provincia  
de Buenos Aires  
frenkelr@bapro.com.ar*

This article sets forth some reflections on the position of the region's countries and the different segments of their domestic financial structures in the international financial system. In the light of the financial globalization taking place in Latin America, it considers the circumstances of the largest countries in the region, looking beyond the stylized arguments of conventional wisdom to analyse different factors influencing the financial situation: sovereignty risk, financial globalization, the degree of financial integration, the cost of capital and the burden of country risk premiums, the link between sovereign risk and fiscal solvency and the consequences of segmented integration. Consideration is then given to courses of action that could reduce country risk. In addition, the role of the different institutional sectors in generating savings is analysed, and the main trends of financial intermediation in the region are considered: banking concentration, the increased involvement of foreign organizations and the role of the public-sector banking system in the circumstances that now prevail.

# I

## The region's place in the international financial system

### 1. Introduction

#### a) *Financial globalization in Latin America*

The involvement of Latin America in the financial globalization process is of 25 years' standing. It was interrupted by the external debt crisis, but in the early 1990s re-engagement took place, and certain emerging tendencies suggested that the region was undergoing a process of increasing integration. The short-lived nature of the Tequila effect seemed to confirm these tendencies. After the Asian crisis, however, the process did not resume. It is not just a case of crises not being "short", in the sense of their after-effects persisting in the economies that suffered them; questions also need to be asked about the tendencies displayed by the financial globalization process since the Asian crisis. Furthermore, new phenomena have appeared, such as financial instability in the United States and the spread of this to the emerging economies of Latin America. There is a potential for financial instability in that country which could have major effects on the weaker economies. Recent cuts in United States interest rates have had a favourable impact, and larger cuts with similar effects are predicted. This is a possible outcome, but it needs to be asked whether it is likely in the post-1997 context, characterized by the "learning process" that the market has gone through in the last three years and the absence of major institutional innovations at the international level. There must also be doubt about the size of renewed capital flows. Can the surge of inflows in 1996-1997 be expected to repeat itself? The financing needs of the region's largest economies require flows on a scale similar to what was seen then, if they are to achieve significant growth rates. If this does not happen, Argentina and Brazil will be in a very precarious situation.

□ This article is based on material prepared for the Joint ECLAC/IDB Project on regional aspects of development financing in Latin America and the Caribbean.

#### b) *Changes in the countries' international financial position*

One change from the 1990s has been the shift in the circumstances of the recipient economies. The international position of the countries has been altered by the accumulation of external debt and foreign direct investment (FDI). Their balance-of-payments structures are different from what they were at the beginning of the decade. The main problem facing heavily indebted countries is debt refinancing and the funding of current-account deficits created by capital service payments (interest and profits). The balance-of-trade deficit has become less important by comparison with the permanent, growing deficits seen in the financial and factor services accounts. In this respect, the situation is closer to that of 1980 than to that of 1990.

The differences in the way economies developed in the 1990s can be analysed in terms of the routes taken towards international financial integration. The underlying idea is that this is a process characterized by hysteresis, where the conditions obtaining at any given moment depend on an earlier course of events. The most obvious example is external debt. Certain routes towards financial integration lead to situations of greater vulnerability, in which crises are more likely to occur. This issue has been closely studied by ECLAC, which has analysed policy options that avoid these routes. Its recommendations are largely based on comparative analysis of the courses followed by the countries, the different policies that were instrumental in determining them and the lessons provided by periods of crisis (whether locally generated or resulting from an increased propensity to contagion). The countries that followed routes leading to greater vulnerability, while they may have experienced and overcome financial and currency crises, now exhibit "structural" situations of greater vulnerability (the ratios between external debt and GDP, the current-account deficit and GDP, external debt and exports and the current-account deficit and exports, the structure of the current account and the structure of the financial system) as a result of the course taken in the past.

The high country risk premiums demanded of these economies are a result of the market's assessments of the more vulnerable conditions obtaining there. These very assessments, however, tend to preserve or exacerbate those conditions, because of the effects of high interest rates and reduced capital flows on growth, the external sector and conditions in the financial sector. These countries are caught in a financing trap. They are more vulnerable to crises triggered by domestic factors or contagion, but the situation has not as yet deteriorated into a currency and financial crisis.

After the crisis, Brazil, for example, corrected a number of the features that characterized its previous approach (devaluation, establishment of a dirty float, fiscal adjustment). Nonetheless, the country could not rid itself of the "structural" inheritance from this previous approach, such as its borrowing ratios and the predetermined component of its current account. The market has evaluated these conditions and applied a high country risk premium, and the economy, although it grew in 2000, remains caught in a financing trap.

Argentina overcame its crisis of late 2000 with the help of an international rescue operation, but without making any changes to the policy that had set it on its previous course (this included a contractionary fiscal adjustment the year before, which had no effect on the risk premium). The market was reassured in the short term, but the risk premium continued to reflect the trap the country was in.

What follows looks beyond the stylized arguments of conventional wisdom to highlight factors that influence the situations faced by the region's largest countries.<sup>1</sup>

## 2. Beyond the stylized arguments

### a) *Sovereignty risk*

A national border marks out a political and legal jurisdiction, within which the sovereignty of the government and other institutions of the national State prevails. Under particular circumstances, a nation's authorities may decide on or endorse non-compliance with certain contracts, an aspect of sovereignty that limits the ability of foreign economic agents to enforce contracts involving them. This is an irreducible risk of sovereignty. There is no reason to suppose in principle

<sup>1</sup> The factors dealt with are mainly those affecting Argentina, Brazil and, to a lesser extent, Mexico, but in some cases they are also relevant to other countries in the region.

that this risk is a very significant one, but there is a tension between the financial globalization process and the institutional conditions of nation States, and this may result in situations where financial integration is segmented.

### b) *Financial globalization*

This process is almost three decades old. It seems reasonable to date its beginning to between 1971 and 1973, when the United States broke the dollar's link with gold and the currencies of the main developed countries were floated. This was followed by a sequence of liberalization and deregulation of international capital movements and national financial systems. Competition in the market acted as a strong driving force, so that the liberalization of financial flows among countries stimulated and was stimulated by the liberalization of national systems. The emergence of new international business created pressure for lower costs and less regulation at the domestic level. Conversely, the new opportunities opening up in certain countries encouraged deregulation of transactions between countries. The reform sequence was paralleled by rapid growth in the volume of cross-border financial transactions.

This process of increasing integration was and is largely confined to the developed countries. The largest economies in Latin America were part of it from the outset, however. First Brazil, and later on Mexico, Venezuela, Argentina and Chile were major recipients of capital in the 1970s. The two last named, along with Uruguay, then pioneered drastic liberalizing reforms that foreshadowed those applied across the region in the 1990s.

The participation of Latin America in financial globalization was interrupted by the 1980s debt crisis. This resulted in a hiatus of eight years or so during which voluntary financing evaporated. In the 1990s—following Mexico's signing of the Brady Plan, say—Latin America once again became a vigorous participant in both aspects of globalization, through far-reaching liberalization reforms and increasing flows (and ebbs) of capital.

### c) *The extent of financial integration*

In the experiments carried out first in the Southern Cone, then on a larger scale in the 1990s, international financial integration was clearly what the intellectual backers of the process had in view. Full integration is tantamount to the establishment of global financial

intermediation whereby the yield on the public's deposits, on the one hand, and the cost of capital for borrowers, on the other, are the same for transactions that are economically equivalent (in terms of maturities, risks, collateral, etc.), regardless of the geographical location of savers and borrowers.

Full integration would minimize intermediation costs, reduce the cost of capital to developed country levels and, insofar as the relative underdevelopment of our countries means there are greater opportunities for new business, result in investment and financing flows that would tend to narrow the development gap.

By comparison with the financial isolation that prevailed from the crisis of 1930 until well into the 1960s, it is unquestionable that the globalization process has brought about a significant degree of financial integration among the developed countries and between these and "emerging markets". However, financial integration among developed countries, advanced as it is, is still far from complete. Nominal interest rates are only aligned in cases where operations are insured in the currency futures markets. In general, there is no tendency for real interest rates to equalize. The citizens of each country show a marked preference for local assets. Investment rates are closely correlated with domestic saving rates. In short, although the level of integration is high by historical standards, there is still significant differentiation among the developed countries' financial markets.

The degree of financial integration between developed and underdeveloped countries is even lower. This is due not only to the fact that globalization involves just a small proportion of countries with "emerging markets", but also to the way in which these markets are integrating. Even at times of strong activity, the volume of financial flows is far lower than what theory would suggest in a situation of full integration. In the developed countries, investment in emerging markets is largely carried out by specialist agents and accounts for just a small proportion of their residents' assets.

#### d) *Segmented integration*

For the region's larger economies, the first stage in the reincorporation of Latin America into the globalization process in the 1990s, as discussed above, was the conversion of the hangover of public-sector external debt into Brady Bonds, which was negotiated in the 1980s. Readmission to the voluntary market coincided with the flotation of a large quantity of public bonds

whose ownership diversified in an active secondary market. Public debt bonds were thus the basis for the region's new investment market from the outset. This public debt market was subsequently enlarged by government issues.

Since they represent dollar commitments, the only risk inherent in public external debt bonds is that of default. The price that the market sets on this risk (the country risk or sovereign risk premium) is measured as the difference between the yield that would be obtained if the bond were purchased at its current price and the yield from a bond with similar financial characteristics issued by the United States Government, the dollar borrower whose default risk is lowest.

The evolution of sovereign risk premiums provides no evidence to suggest that the international system that has developed with globalization is tending towards full financial integration. Quite the contrary. The experience of the last three years—the period that began with the Asian crisis—suggests that the system has developed into one of segmented integration, in which the cost of capital is systematically much higher for the emerging economies of Latin America than for the developed countries.

#### e) *Country risk premiums*

Convergence towards full financial integration would have meant a continuous reduction in Latin America's country risk premiums. This has not happened. As an example, let us look at how the premium, as measured by the J.P. Morgan Emerging Markets Bonds Index Plus (EMBI+), moved in the 1990s for Argentina, the region's most financially open and deregulated economy. At no time did the monthly premium average fall below 280 basis points, and it only went this low on a couple of occasions. After falling during the first part of the 1990s, it bottomed out at that level in the early months of 1994, only to begin rising again in March that year, when the United States raised interest rates. The monthly average then rocketed to 1,800 basis points with the Tequila effect before slowly sinking back to reach its previous low the month before Thailand's devaluation. Following the Asian crisis, the monthly averages never fell below 400 basis points, and the Russian and Brazilian crises took them back up to over 1,000. In 1999 and 2000, when there were no further national financial or currency crises, the premium never dropped below 500 basis points, and in 2000 it tended to increase in response to other events, first the NASDAQ fall, then the rise in the oil price.

Figure 1 shows the monthly average risk premiums for Argentina, Brazil, Chile and Mexico, measured by EMBI+. The relative level of the emerging Latin American economies' risk premiums is associated with certain structural characteristics in those countries, indicative of their solvency. For example, as table 1 shows, recent premium levels for Chile and Mexico, on the one hand, and Argentina and Brazil, on the other, are associated with their respective external debt/export ratios. Local ingredients, such as periods of political uncertainty in Argentina, have also influenced relative variations in Latin American premiums. If their evolution is tracked over the whole of the 1990s, however, it is plain that they all fluctuate in unison as a result of national crises and, more recently, outbreaks of uncertainty from other sources in developed country markets.

f) *Contagion and herd movements*

These synchronized fluctuations are the result of herd movements among investors. The very possibility of such movements was discounted in the first half of the 1990s by the orthodoxy that then prevailed both among international organizations and governments and among analysts. This diagnosis obtained recognition with the Mexican crisis, however, and was irrefutably confirmed by the Asian crisis and its aftermath.

The idea was then elevated into the concept of contagion, which has now been incorporated into the

TABLE 1  
**Argentina, Brazil, Chile and Mexico: Debt ratios**  
(Percentages)

Year	Exports <sup>a</sup> / GDP	External debt <sup>b</sup> / GDP	External debt <sup>b</sup> /exports <sup>a</sup>
Chile			
1997	28.1	35.2	1.3
1998	26.7	43.4	1.7
1999	29.0	50.8	1.8
Brazil			
1997	7.6	25.5	3.4
1998	7.4	30.1	4.0
1999	10.2	44.1	4.3
Mexico			
1997	30.4	38.1	1.3
1998	30.8	38.3	1.2
1999	30.7	33.4	1.1
Argentina			
1997	10.6	42.6	4.0
1998	10.4	47.2	4.5
1999	9.8	51.1	5.2
2000	11.0	52.0	4.7

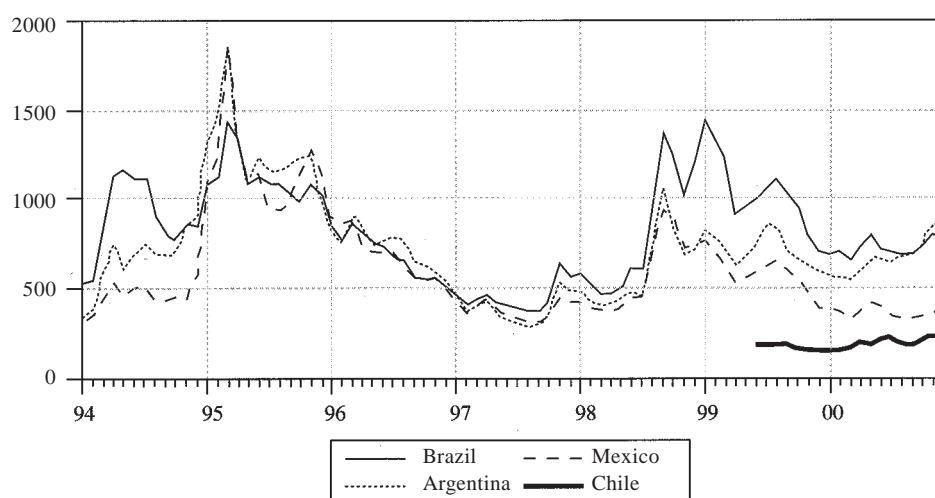
<sup>a</sup> Real goods and services exports.

<sup>b</sup> External debt of the public and private sectors.

thinking of the International Monetary Fund (IMF) and provides the basis for some of its new lines of action. However, this concept is used only to characterize herd movements brought on by national crises. Yet, was it

FIGURE 1

**Argentina, Brazil, Chile and Mexico: Country risk premiums**  
(Monthly values of EMBI+)



not a similar contagion effect that was triggered by the fall of NASDAQ technology shares, at the end of a long bubble? Do not the effects of the oil price rise fall into the same category? The impact of this rise on Mexico's premium illustrates this last point: although the rise in the oil price benefited the Mexican economy, the country's sovereign risk premium rose along with those of the rest of the region.

Recognizing that these phenomena are also a form of contagion is important for the design and promotion of international measures to foster the stability and improve the workings of the globalized market, as we shall argue later on.

We can imagine any scenario for the future, from a world financial crisis and a return to isolation and the negotiation of external debts, to market stabilization and gradual convergence towards full financial integration, because it is a fact that the future is irremediably uncertain. But before imagining the future, we need to recognize the fact that in the three years since the Asian crisis, and a decade after Latin America re-entered the international financial market, country risk premiums have meant that the cost of capital for government issues in Argentina and Brazil, under the best short-term conditions experienced during the period, has been approximately double the United States interest rate, and significantly higher than Mexico's. In Latin America, only Chile's premium is close to those of Hungary, the Republic of Korea, Malaysia and Poland, the emerging markets with the lowest sovereign risk premiums.

g) *Sovereign risk involves more than fiscal solvency*

It might be thought that to sterilize the effects of sovereign risk it would be enough to balance the budget and have no need of further issues. It could be argued, and many have done so, that the whole problem lies with the public-sector finances. This is not the case. Chile, for example, has a fiscal surplus, but its premium is far from negligible. Where is the sovereign risk in a case like that? A country's finances may be in balance or even in surplus, but this does not guarantee that its economy has the foreign currency resources needed to meet dollar-denominated debt servicing and repayment obligations. Furthermore, it is possible that the government may have the foreign currency resources it needs to meet its own requirements, but not those of the economy as a whole, so that there may not be enough dollars to service private-sector external debt. In these circumstances, the authorities may choose or

be obliged to suspend the convertibility of the national currency (or payments abroad, in the case of a dollarized economy) and force agents to default on contracts. Sovereignty makes this possible. Sovereign risk involves more than the risk of fiscal insolvency.

h) *The country risk premium determines the economy's cost of capital*

The dollar interest rate yielded by public debt securities traded in the secondary market provides the entire market with a measure of sovereign risk and tends to determine the cost of capital for the country's businesses, in both foreign and local currency. In the first place, it is the opportunity cost for foreign direct investment (FDI) capital. Secondly, it sets a floor for the cost to local companies of obtaining international resources. Thirdly, it sets the floor for the international funding costs of banks, and thus for the marginal costs of those obtaining foreign currency financing locally. Lastly, it also tends to set the floor for the cost of local currency financing. Brief consideration of this last point will allow us to examine other peculiarities of segmented integration.

We mentioned earlier that local investors in the developed countries preferred assets in their own countries, denominated in their own currency. Even when financial systems are highly interconnected among countries, this preference means in principle that their monetary authorities can use policy to set a local currency interest rate that is systematically lower than the international rate (i.e., the rate that the investor would obtain from a foreign currency investment). In our economies, for a number of reasons which cannot be gone into in detail here, preferences are quite the reverse. As financial openness works both ways, local agents are in a position to carry out arbitrage between local currency assets and dollar assets. For this reason, other than in the exceptional case where there is a systematic and predictable tendency for the local currency to appreciate, the real local currency interest rate needs to be at least equal to, and generally higher than, the dollar interest rate.

i) *The consequences of segmented integration*

Persistently high country risk premiums are an unforeseen effect of financial globalization. They have a number of negative consequences. Firstly, high interest rates reduce investment and check growth. Secondly, they produce a regressive income distribution

trend. Thirdly, they make it necessary to transfer revenue abroad, directly through external debt servicing and indirectly in the form of FDI profits. Lastly, in some cases (notably Argentina and Brazil) they result in unsustainable macroeconomic tendencies, as external debt liabilities burgeon.

It might seem that one way of coping with this situation would be to go into reverse and take the country out of the financial globalization process. There does not seem to be any simple way of doing this, however. External public- and private-sector debt is currently the main factor anchoring countries to the international financial system. Regular debt servicing absorbs a large proportion of gross capital receipts.

In the early 1990s, the countries had some degree of choice about the type and extent of financial liberalization they introduced in the face of pressure from large capital inflows. The situation today is completely different for a number of countries, whose main problem is now to obtain financing for regular debt renewals and, crucially, to do so at prices lower than those currently being paid. Consider the examples of Brazil and Argentina. In the early 1990s, Brazil had a trade surplus of some US\$ 12 billion and a balanced current account. The country was trying out ways of restraining capital inflows, because of their destabilizing monetary effects. In 1999, following a trade and financial stabilization and opening process, and a year on from the crisis and the corrective measures, Brazil's external accounts showed a trade balance that was in rough equilibrium and a current-account deficit of some US\$ 25 billion, owing to interest payments and factor services. Between the early 1990s and 1999, the profit, dividend and interest servicing account deficit rose from 22% to 40% of visible exports. Similarly, Argentina in the early 1990s had a trade deficit of some US\$ 2 billion and a US\$ 6 billion current-account deficit. In 1999, at the trough of the recession, the trade balance was in deficit by US\$ 700 million, while the current-account deficit was US\$ 12.3 billion, because of interest and capital servicing. The capital service and interest account deficit rose from 20% to 33% of visible exports between the early 1990s and 1999.

#### j) *Multiple equilibria*

Relative risk premium levels reflect the market's assessment of different degrees of vulnerability and are correlated with solvency indicators, as we pointed out earlier. Greater relative vulnerability implies a higher likelihood of crisis in the face of an equivalent shock.

The occurrence of a crisis, regardless of what triggers it, may be rationalized as a movement from one equilibrium to another in a multiple equilibria model (this is the main application of multiple equilibria models in the literature on the subject). Any economy can suffer a crisis when faced with a shock of sufficient magnitude, but there are configurations which are more likely to experience crises (to "jump" from the current equilibrium to a crisis situation). Thus, all economies have two "equilibria": the current equilibrium (the good one, if there is no crisis) and the crisis one. In some economies the current equilibrium is more unstable than in others, i.e., it displays greater vulnerability.

What has been said so far can be supplemented by two considerations. The first is that it is possible to reason in terms of tendencies, classified by their potential for growth and sustainability, rather than regarding any non-critical situation as a single "equilibrium". The economy may be stuck for a longer or shorter period in a "trap" of high interest rates, low growth and high vulnerability. It is then following a path that is unsustainable in the long term (owing to the tendency of debt ratios to rise explosively), but it may operate in this situation for a certain amount of time without actually going into crisis. This configuration is the combined result of past movement towards some degree of international financial integration and the assessment that the market makes of the risks of this. Thus, instead of distinguishing between two equilibria (crisis and non-crisis), we can distinguish between two tendencies: the low growth trap configuration and a virtuous growth tendency.

The second consideration is that the market's assessment, i.e., the risk premium it demands and the volume of the country's assets it is prepared to absorb, will be instrumental in determining whether or not crises occur and what type of tendency is followed by the economy. For example, all other conditions being equal, an economy may find itself in a trap configuration or in a virtuous growth configuration, depending on its country risk premium and the flows of capital it receives. The economy may have become caught in a trap configuration because of a contagion effect, but once it is in this position its indicators will tend to worsen and the market's negative assessment become a self-fulfilling prophecy. A lower country risk premium and an increased flow of financing could restore virtuous growth, but investors will not alter their expectations unless a coordinating signal is received.

From the multiple equilibria perspective, international action to reduce sovereign risk (for

example, the creation of a lender of last resort function) can be justified as a crisis prevention measure, as it reduces a country's propensity to make the jump to the crisis equilibrium. Similarly, the distinction between types of tendency can be used to justify intervention as being necessary in particular cases to allow the economy to escape from a low growth trap and enter a virtuous growth path, or at least to make this possible.

### 3. Courses of action that can reduce country risk

The ultimate reason for sovereign country risk premiums is that very sovereignty which nations have in our times. The financial globalization process could have had another issue, but the situation it is now in was always one of the likely outcomes. When dealing with the facts of segmented integration, we generally reason by analogy with national financial systems to identify the failings of the system created by globalization. We observe that this international system is lacking in many of the institutions that have been built up over time in national systems to improve their stability and the way they work. The institutions and track records of individual countries suggest that it would be advisable to design institutions that can play similar roles internationally. Establishing such institutions, however, would in each case mean putting an end to different attributes of national sovereignty. This is so even as regards the production and distribution of fiscal and financial information, which is the area where most progress has been made in the discussions and agreements of the International Financial Architecture (IFA) forums. It is even more essential when it comes to the establishment of international bodies to carry out prudential oversight and regulation, an issue with which little progress has been made and concerning which misgivings have been expressed by some developing countries, their fear being that risk provisions could restrict the flows of capital they so much wish to attract. The multilateral IFA debates are important, but we do not expect them to produce solutions in the near future. Other ways need to be sought.

Insofar as sovereign risk is essentially the danger of breach of contract resulting from the practical impossibility of compliance, it tends to fall when additional guarantees exist in the form of contingent access funds available to countries that encounter difficulties. This function is similar to that of a lender of last resort, a role played nationally by the central banks of many countries. It is possible to imagine this

role being taken on by all sorts of institutions, and the United Nations should continue to encourage discussion of the subject in IFA forums. Considering the positions that the United States has taken, however, and will probably continue to take under its new Government, it seems clear that for the foreseeable future international financial functions will continue to be performed mainly by the Bretton Woods institutions.

The IMF instrument whose function comes closest in formal terms to that of providing guarantees to reduce sovereign risk is the contingent credit line, for which regulations were recently produced. The take-up conditions for this credit line are so stringent, however, that countries which are able to meet them feel no need to make use of it, while those that need it most do not meet the criteria. In parallel, IMF has established another credit line—the supplementary reserves service—whose amount is not predetermined and whose access conditions are far more discretionary. The Fund created this line during the Republic of Korea rescue operation, applied it in the operations that followed the Russian and Brazilian crises, and recently granted it to Argentina.

By creating this line, IMF has taken a significant step towards acting as something akin to an international lender of last resort. It would seem reasonable to try to progress further along this route, which looks to be the most viable one, although the conditions of access to the contingent credit line should continue to be discussed. If further progress is to be made towards significant reductions in risk premiums, the funds available will have to be increased, and the circumstances in which they can be drawn upon will have to be extended. Access would be more open, for example, if the idea of contagion were broadened to take in the effects deriving from outbreaks of uncertainty of various types in the developed world financial market, as discussed earlier.

Greater access to funds—whether made available by the public sector or provided in the markets and indirectly guaranteed by developed country governments—and broader and more automatic conditions of access could have a significant effect on risk premiums and would improve the workings of the system because they would reduce the likelihood of crises arising. But it will be difficult to achieve these conditions unless further sovereignty is ceded to multilateral bodies, because it is this cession of sovereignty, operating in conjunction with greater availability of contingent funds, that reduces sovereign risk. One example of this type of effect is the zero risk



premium paid by the Greek economy because the country is a member of the European Union.

In theory, ceding sovereignty to multilateral bodies does not mean losing it, but rather exercising it in a shared, negotiated manner. However, IMF and the World Bank are not organized democratically. It is going to become more and more controversial (and

legitimately so) for countries to give up sovereignty without securing in return a greater say in the running of the bodies concerned. Consequently, the agenda should not only include extension of the functions discussed earlier, those of a lender of last resort, but should give priority to addressing the way multilateral bodies are run.

## II

### Domestic financial systems

Throughout the 1990s, the countries of Latin America followed, to a greater or lesser degree, the economic policy agenda inspired by the so-called Washington Consensus. The theoretical underpinnings of the measures involved were provided by a vast literature whose conclusions strongly backed a market-friendly approach to solving the region's main economic problems, including those connected with the financial system. But the results of applying these measures often fell far short of the expectations aroused by their backers, and on occasion were even diametrically opposed to them. Furthermore, too little account was taken of how specific the problems of each country were, and on occasion crucial "details" of their institutional structures were overlooked.

What is more, the policies applied were not informed by an objective reading of relevant international experience from outside the region. There are certain lessons that can be drawn, for example, from long-term processes in the countries of South-East Asia. Although some of the strategies applied there, such as the large-scale use of forced saving mechanisms and/or sectoral promotion policies involving an effective system of rewards and punishments, would seem to be difficult to replicate under the current economic and political conditions of Latin America, we believe they should not be dismissed out of hand, particularly if a sceptical view is taken of the results of the policies applied in the 1990s.

#### 1. Saving

The literature on the subject recognizes the difficulties involved in determining with any accuracy the impact of certain key variables (such as the interest rate) on

the saving rate. Only very rarely, however, is even the most tentative reference made to the possible influence of purely cultural factors on saving. This is consistent with the profession's "aversion" to accepting that variables of this type might be relevant. If it is acknowledged that they do play a role, it becomes obvious that "material incentives" to greater saving need to be combined with a communications policy that seeks to alter the consumption patterns of Latin American households. In a way, this argument reaffirms Prebisch's view that one of the factors holding back growth in Latin America is the imitation of consumption patterns originating in societies with much higher per capita incomes than the region's.

Again, studies seeking to guide policy-making often contain statements that, although they are supported by the theoretical literature and meet with general agreement among economists, should be expressed more cautiously. For example, reference is often made to the importance of a stable macroeconomic environment as a prerequisite for any strategy to increase saving, and stress is laid on the benefits of having a diversified array of financial instruments. Yet in the United States, where not only is this prerequisite met but agents have more saving vehicles available than in any other economy, the household saving rate has been negative over recent years. Paradoxically (from a conventional point of view), there is evidence of circumstances in which household saving reacts positively to increased uncertainty.

It does not seem such a simple matter to stimulate household saving in Latin America purely on the basis of market incentives. The household saving rate is very low, and in some cases negative. In our region, in fact,

saving is carried out mostly (and in a greater proportion than is the case in developed economies) by the corporate sector. Despite this difficulty, there can be no doubt that private-sector saving in Latin America will only increase if household saving is stimulated.

a) *The pension system*

In the first place, it is routinely claimed that an unfunded pension system has a negative impact on saving. This is true in the first instance. But it should not be forgotten that what ultimately matters is not what items in the public accounts show disequilibria, but how large the overall fiscal deficit is. It is possible to design an “unfunded” pension system that is actually fully funded through higher taxes and contributions (whereupon, according to the argument referred to, there would be no negative impact on saving). Yet if we accept that there is always a maximum limit, determined by the characteristics of the economy concerned, on the total tax burden that will be borne, the corollary of the equilibrium thus achieved in the pension system would be a larger imbalance in other areas of the public accounts, as the level of other taxes would have to be below what it might have been had pension contributions been low.

Secondly, while the rationality of agents should not be exaggerated, it would seem that in Latin America the future beneficiaries of pension systems generally apply a high discount rate to their future incomes, as it is highly likely that the promises incorporated into current pension laws will not be able to be kept in full. Again, the authorities should try to make people aware of the urgent need to carry out additional saving to supplement the income that will be provided by the pension system.

One view that has won growing support is that it would be advisable to bring in individually funded systems, as has already happened in a number of Latin American countries, in view of the way such schemes stimulate the development of the capital market. In practice, however, this connection is weaker than the literature suggests, and the empirical evidence does not show the kind of dynamic impact that was predicted by the backers of pension reform in the 1990s.

A large proportion of funded system assets are invested in public-sector securities issued by governments mainly for the purpose of financing the imbalance caused by the transition from one system to the other. In some cases, these bonds pay quite high interest rates, raising doubts about the long-term solvency of the public sector.

One possible solution that falls somewhere between the two extremes is a State-administered funded system. The administration costs of private-sector funded schemes are very high, and have undesirable consequences for distribution owing to the structure of the commissions charged by pension fund managers (PFMS). Early experiences in Latin America show that these systems are inefficient. Competition among PFMS is through advertising rather than performance differences, which means that scarce social resources are being used for a sterile activity that is short on the real information content needed to guide rational decision-making by contributors.

On top of this, there are the costs of regulating and overseeing the system. Indeed, it can be argued that the system would not be efficient even if agents based their decisions solely on the yields obtained by managers. This is because regulatory systems limit the scope for differentiating portfolios and because a good past performance does not always mean higher yields in the future. Taking the argument to the extreme, in more or less efficient markets the likelihood of exceptional yields being obtained is necessarily low, and for the system as a whole it is non-existent.

For these reasons, it can be argued that a State-run funded system may be the ideal. But the difficulties of implementing such a scheme in Latin America are not minor. The main objections centre on its potential vulnerability to any pressures from government and interest groups. Indeed, it is partly because of this vulnerability that the old unfunded systems are unviable. But consideration should be given to the possibility of giving a State system of this kind a degree of independence similar to that enjoyed by some central banks, with authorities whose terms in office are longer than those of the political authorities. Having a high proportion of public debt in the portfolios of government-run funded systems does not invalidate their “optimality”, as private systems also have a high proportion of such securities.

If it is generally agreed, however, that the best thing is to continue along the route of replacing unfunded systems with private-sector funded systems, it is vital for the workings of the latter to be improved. There are two areas in which urgent progress is needed. Firstly, there need to be better incentives to bring down administrative costs that do not feed through to better customer service. Secondly, there have been instances of situations and behaviour that have raised acute conflicts of interest to the detriment of savers, arising because of a failure to separate PFMS properly from

banks. In some cases, PFMS have been “pressurized” to purchase packages of shares at above market prices on the occasion of mergers or the creation of holding structures. There have also been cases of banks “dumping” unwanted assets on to PFMS, sometimes by means of triangulation with other organizations.

These problems, which arise because dividing walls are weak or non-existent, and which affect more than just pension systems, have been found even in circumstances where strict compliance with the relevant legislation (which is mainly “imported” from countries with good practice) would have ruled out the operations we are referring to.

This shows how important it is to enforce compliance with existing regulations, something that appears to be inadequate in the region. In particular, regulatory bodies set up by governments show a tendency to be “captured” by the larger of the institutions being regulated. Consequently, it is vital to give greater stability to officials working in the regulatory agencies and guarantee their immunity to decisions by the political authority. Again, officials who leave these regulatory bodies need to be debarred from going straight over to work for the firms they were regulating, with no transition period.

One way of encouraging higher saving rates would be to introduce additional voluntary contributions, but with liquidity characteristics that would make them more attractive to future pensioners. It seems to be the absence of this factor that largely accounts for the low level of additional contributions in systems that permit them.

#### b) *Company saving*

We mentioned earlier that saving in Latin America is carried out mainly by the corporate sector. In the aggregate, retained profits account for a greater share of company financing in the countries of the region than in developed countries. In addition to the use of tax incentives and accounting rules to discourage dividend distribution, company saving could be stimulated by policies to make investment more attractive, since when projects yield high returns there is a “natural” incentive to reinvest profits. This is because the use of internally generated funds is the lowest-cost option, as is shown both by the theoretical literature on financing and the empirical evidence from industrialized and less developed countries. Companies have recourse to bank borrowing, bond placements or new share issues when internal funds are insufficient.

This gap between the cost of internal and external financing, which constitutes the external financing premium, is relatively high in the Latin American countries, probably because information asymmetry problems are more severe there.

It would seem that the borrowing of Latin American companies is at a suboptimal level (they are “under-leveraged”), which is consistent with the existence of market failures in the financial system. This may seem paradoxical at first sight, as most of the region’s tax systems provide strong incentives to borrow. What this brings to light is the need for financial deepening of the economy and the development of capital markets to stimulate saving and channel it towards the companies with the most profitable projects. A policy of this type, however, should try to correct the bias against small and medium-sized enterprises (SMEs) produced by any system that encourages company borrowing. It is vital to ensure that SMEs have better access to credit.

#### c) *Public-sector saving*

A prudent fiscal policy does not necessarily imply a fiscal surplus or zero deficit, since a growing country can finance moderate deficits without this necessarily being destabilizing. Again, warnings about the advisability of achieving balanced budgets or surpluses are formulated in very general terms and treat the countries of the region as if there were a level of homogeneity among them which does not in fact exist. The blanket imposition of fiscal surplus goals is too arbitrary and may be detrimental, even in terms of long-term fiscal solvency. The differences among the countries in terms of fiscal institutions and political organization mean they have varying degrees of freedom in the running of fiscal policy. These constraints, which are particularly important in large federal countries, will have to be taken into account if proposals are drawn up for reforms (regionalization, for example) that aim to tackle the root of the problem. Likewise, self-imposed budget deficit limits are difficult to justify when countries have very little room for manoeuvre in monetary and exchange-rate policy, as in practice these would mean that they were unable to moderate the shocks that affect their economies to even a small degree.

Again, there is unquestionably a need to free up resources (savings) for private-sector investment. In Latin America, however, there is no lack of projects offering a high social return, higher even than that

available from the projects that could be taken on by the private sector if more resources were freed up by the public sector.

Governments sometimes make heroic fiscal adjustment efforts to achieve fiscal targets laid down in agreements with IMF; this forces them to carry out operations that generate associated costs, which can be considerable in the long term. One example is the sale of public-sector companies or shareholdings or the granting of concessions at times when the circumstances are not at their most propitious, in a determination to comply with the letter of the fiscal targets accepted. This means that some of the revenue potentially obtainable from the private sector is foregone, and is actually detrimental to long-term fiscal solvency insofar as the present value of public-sector revenue is reduced.

On another level, the public sector often plays a further role: that of obtaining the currency needed to finance the current-account deficit. In certain of the region's countries, the private sector runs a structural deficit in its external operations and its contribution to the accumulation of reserves is negative, whereas the public sector obtains currency resources in excess of its external financing needs and thus does contribute to the accumulation of reserves and to the financing of the private sector's external deficit. Thus, a lower fiscal deficit could mean a weaker currency and/or difficulties in financing the current-account deficit of the private sector.

#### d) *How savings are used*

The effort made in the last decade to increase the range of the saving instruments issued by residents and of the tax and regulatory incentives used to encourage their take-up in Latin American markets has not had the results hoped for. In the region, there are numerous examples of financial savings rising while the saving rate has fallen or remained unchanged. There are many instances of successful development where the consumption of certain types of goods has only taken off once a considerable level of development has been attained. In Latin America, for example, imports of consumer durables have a large negative effect on the balance of payments. In this case, applying particular restrictions (such as tariffs) helps increase saving.

Apart from the investment financing aspects, one subject of key importance is the need to raise the efficiency or productivity of investment and improve on the very poor record our countries have in maintaining social capital (which implies a high

depreciation rate). In Latin America there is undoubtedly a great deal of scope for improving the situation through better maintenance, even without changing the net investment rate.

## 2. Financial intermediation

### a) *Bank concentration*

It has to be asked whether the tendency towards greater bank concentration is not a cause for concern. The answer is far from categorical. Not all the region's financial systems show a high level of concentration. Furthermore, any attempt to reduce this level may clash with other objectives, such as keeping a high market share in the hands of local banks. Indeed, at a time like the present, when financial globalization is making giant strides, local institutions can only retain a significant share by growing to a size sufficient to allow them to compete with foreign banks and/or to act as a barrier to entry for potential competitors. Ultimately, the problem of moral hazard deriving from the existence of organizations that are "too big to fail" (and thus enjoy a form of implicit insurance) needs to be tackled by strengthening the regulatory and bank supervision framework. The size of banks is not a problem in itself (as is demonstrated by the case of Canada, among others), unless the institutional framework is very weak.

Nor is there any justification for overdone concern about the perils of higher bank concentration if this is the result of greater participation by foreign companies, especially in the case of top-ranking international banks. The moral hazard is less in this case, as it is less likely (and less politically acceptable) that governments would go to the aid of foreign banks rather than public-sector or local private-sector banks. It may be argued that the risks of concentration are not unconnected with the nationality of the banks concerned.

### b) *Greater participation by foreign companies*

Although in principle, and as a very broad generalization, the international correlation of systemic risks increases when foreign financial institutions have a larger presence, this does not appear to be a very important factor in the Latin American context. Preventing banking crises from being "imported" from the developed countries is not, and should not be, a priority concern in our countries, where local sources of upheaval loom much larger. Although in theory the correlation referred to increases, in the region this is associated with a moderation of risk since, in general,

large foreign banks are perceived as being more solvent than local ones.

This is the case, firstly, because banks coming in from outside are generally closer to financial “best practice” than Latin American ones. Secondly, because (up to a point) the head offices of foreign banks come to act as lenders of last resort for their local subsidiaries. In fact, there has even been a case of a large bank from an emerging market in Latin America (Banamex) capitalizing a bank it controlled in Argentina (Bansud) when this was in great difficulties, to avoid the reputation costs that would have resulted from bankruptcy. Consequently, it is to be hoped that banks whose parents are in more developed markets would act with similar or greater zeal to solve any problems that their subsidiaries in the region might face.

From another perspective, lastly, the presence of these banks means that depositors can diversify their portfolios among institutions with an international reach, which reduces the country risk they assume. This is better than local investors reducing their country risk by sending their capital abroad.

By and large, the experience of Latin America seems to show that in the region it is better to have a fairly concentrated system of universal banks. There have been cases in which competition within weak regulatory frameworks has led banks to adopt excessively risky strategies that have exacerbated instability in the financial system. By contrast, higher profitability and less competition mean a lower likelihood of bank runs and less of an incentive to take risks. Again, a universal banking system dominated by large organizations can help to improve the quality of management and governance in these institutions.

None of this means, however, that bank concentration and increasing participation by foreign companies do not have negative implications that need watching closely. Firstly, excessive concentration or oligopolization may allow the dominant companies to generate high quasi-rents; in this case, State intervention would be justified by the need to correct this market failure, and would require a regulatory framework that stipulated maximum percentages of market share and outlawed mergers that created obstacles to competition. It may, however, also justify the role of “first tier” or retail public-sector banks, insofar as they can operate as “controls” and oblige private-sector banks to set prices closer to what they would be in a more competitive situation.

Secondly, larger banks (and particularly foreign ones) usually follow more conservative lending

practices. It is also common for regional banks, or banks catering to risky sectors, to be replaced in certain areas by these international banks, which drastically reduces the supply of credit for those very firms and individuals that find it hard to get sustained access to funding (farmers, SMEs, businesses in disadvantaged regions, low-income or medium/low-income families, etc.). What is more, the degree to which lending responsibilities are delegated falls as the participation of foreign banks rises. In practice, all loans for large sums, particularly when they are connected with the financing of investment projects, are approved in the country where the bank has its head office. This is clearly an undesirable result of greater foreign bank participation and suggests that there is a need to ensure the survival of a strong local banking system, be it public or private. Again, while it is difficult to quantify the scale of this effect, from a macroeconomic point of view the concentration of lending responsibilities in the head office increases the correlation of the cycle among the Latin American countries and between these and the home countries of the foreign banks. The sensitivity of investment to the risk premium would increase as well.

### c) *Public-sector banking in today's circumstances*

For all the reasons given above, the centrality of the role that belongs to the public-sector banking system should not be underestimated. Unquestionably, though, the way this role is played has to be suited to the new international and local circumstances. In a number of the region's countries, many of the leading commercial banks are still in the hands of the State, which has retained a key position in domestic financial systems. Public-sector banking played a decisive role in Latin America during the import substitution industrialization period. Directed credit increased rapidly, covering many sectors, and became one of the primary tools for supporting the development of industry, agriculture and social programmes. Public-sector banks tried to make up for the shortcomings of weak domestic capital markets as a source of long-term financing, but serious management problems resulted in huge losses building up, and these have not yet been cleared despite the fact that directed credit policies have become more focused and less ambitious.

The vast majority of public-sector banks did not give credit risk assessment the importance it deserved, and their loan recovery rates were alarmingly low, while arrears were extraordinarily high. These institutions

were very vulnerable to pressure from interest groups, and often overreached themselves in their quest for profits. In short, they became an extremely inefficient mechanism for channelling subsidies. Even some developed countries have had costly experiences with public-sector first tier banks. A recent case is that of *Crédit Lyonnais*, in France, which has unveiled large losses despite having a highly professional staff.

Taking all this into account, what should be the function of State banking in Latin America? Both economic theory and the experience of East Asia suggest that focused, well administered lending programmes can work well in many cases. But it needs to be asked which channels are the most appropriate for implementing a policy of this type. Given the serious adverse effects that can be produced by a poorly functioning first tier State banking system, it seems imperative in many cases for the State system to be turned into a second tier one. First tier State banking would be justified in cases where the private system did not provide the necessary services in particular regions, or did so inadequately (presumably because profitability there was low), or because the market was segmented in a way that was detrimental to SMEs, or because the private-sector financial system was highly oligopolistic and the State bank could act as an effective control. There is also a further role that public-sector banking can play when financial systems have particular institutional configurations (for example, in a convertibility regime, when the central bank is restricted in its role as lender of last resort).

In any event, the continued survival of State banking, be it wholesale or retail, can only be justified if major reforms are made in the management of these institutions. First tier State banks need to apply the regulation, supervision and risk rating standards that prevail in the private sector. There is also a need to avoid pointless overlaps, with State banks “competing” with one another in the same markets; this is inefficient, and results in a waste of social resources. The need for a bank that can act as a control or follow countercyclical policies when private-sector banks are showing great risk aversion does not mean that there should be numerous public-sector banking institutions. Such multiplicity would create the risk of sterile competition among them for benefits of a political nature.

There are some basic principles that public-sector banks should observe, many of which require far-reaching institutional redesign. Firstly, any subsidy component implicit in the lending practices of these banks should be made transparent and budgeted for.

Correct valuation of subsidies is a prerequisite if taxpayers are to understand the cost of maintaining these institutions, and it is also necessary so that parliament, which is responsible for passing the government budget, can give them their due weight within the ranking of government policy priorities.

Secondly, public-sector banks, like the central bank, should be completely independent of the political authorities. To guarantee this independence, the members of its board need to have a longer term of office than the members of the government executive. In addition, the boards of these institutions need to include directors appointed by the minority in parliament to carry out oversight and auditing functions. Once a certain level of transparency had been attained in the accounts of these banks, performance-related incentive systems could be created for the board and top management.

Thirdly, public-sector or development banks need to give priority to the financing of projects concerned with the production of tradable goods that can increase exports or replace imports. The projects submitted should be ranked by their potential for generating currency. In principle, sectors that can neither generate nor save currency should not receive much credit assistance from this system, but should seek it in the private sector.

Fourthly, the SME sector deserves special consideration. A subsidy component may be justified for these companies, even if their output is not tradable, if their potential for job creation is well above the average. In this case, it might be appropriate to use funds from the budget to subsidize interest rates on loans to SMEs, this subsidy being distributed among the banks on the basis of which of the lending rates proposed was lowest. This type of instrument is very efficient, as a large effect is produced for a relatively small outlay. Leasing is another instrument that can be very useful in counteracting the effects of the high interest rates and excessive collateral demanded before SMEs are granted loans for machinery purchases. In many Latin American countries the legal framework is not at all appropriate for operations of this type, and should be reformed. In particular, banks should be required to set up separate subsidiaries to enter into leasing contracts. It would also be advisable for the lessee to be allowed to write down the asset over the same period as, or a period shorter than, the life of the leasing contract. Furthermore, for contracts of this type to be attractive it is almost indispensable for the instalments payable to be tax-deductible for the lessee. On the demand side, experience shows that an aspect of no small importance

is the way the loan dossier is prepared for the bank. Thought could be given to introducing a Chilean-style consultancy system throughout the region (i.e., subsidizing part of the cost of engaging the services of professionals authorized for this purpose by the State), or to using a simplified submission scheme like that of the Small Business Administration in the United States. In this latter case, the simplified form could be drawn up in agreement with the banks. The two schemes could complement each other if the consultancy component were not confined to the processing of the loan but also included management of the project for which the credit was being sought.

There is broad agreement about the merits of creating or strengthening mutual guarantee societies (MGS). In the region's larger countries, where a significant number of operations could be expected (which would lower the average administration cost), the option of a public guarantee fund could also be considered. If a mixed system were decided on, this fund should act as a provider of counter-guarantees, taking upon itself part of the risk assumed by the MGS. Of course, the existence of a public guarantee fund should never obviate the need for MGS to demonstrate their effectiveness by adhering to rigorous professional standards when evaluating projects. Consideration could be given to a system in which the cost of reinsurance was inversely proportional to the effectiveness of the MGS, measured by the failure rate of the operations supported.

Other instruments whose use should be encouraged are venture capital funds and credit trusts. These can be used to increase the efficiency with which the public-sector resources available are employed and enhance lending capacity through the participation of large institutional investors in the private sector. To optimize the use of trusts, they should be focused on microenterprises and small businesses, as projects of this type are the ones that have the greatest difficulty in obtaining access to the banking system, and thus have few financing options. As regards microfinance, the role of saving and loan cooperatives should not be underestimated. Although the experience of the region is mixed, with some striking successes and failures, these institutions are particularly well placed to provide financing to SMEs and lower-income sectors, while at the same time achieving satisfactory levels of credit recovery. Regulatory standards and legal frameworks need to be adapted, however, to ensure that they can compete with the commercial banks and to solve the problems of governance that frequently afflict them.

Fifthly, public-sector banks should share financing with private-sector ones as far as possible. In other words, excessive participation by the former in project financing should be avoided if practicable. The ideal thing would be to keep public-sector financing down to a minimum, while seeking to share some of the risk (but not the financing) of projects through a system of guarantees.