Universidad de San Andres

DEPARTAMENTO DE ECONOMIA

Priorities for strengthening latin american banking

Mario Teijeiro (Centro de Estudios Tecnicos)

CICLO DE SEMINARIOS 1996

Día: Martes 20 de agosto

9:00 hs.

PRIORITIES FOR STRENGTHENING LATIN AMERICAN BANKING

Mario Teijeiro

Universidad de
SanAndrés

Prepared for the Conference on Strengthening Latin American Banking in a Global Environment.
Buenos Aires, Argentina, March 23, 1996.

Introduction

Latin American banking faces the challenge of achieving sustainable growth in an increasingly competitive financial world. Banking systems of industrial countries have a strong competitive edge because they offer better economic and political stability, legal safety, and tax shelter. Foreign banks also benefit from guarantees of deposits and liquidity support provided by solvent governments. The handicap faced by Latin American banks is even larger in countries with a record of confiscating deposits. These factors help explain why a large proportion of Latin American savings is today intermediated abroad. They also explain the growing participation of foreign banks in Latin markets.

The purpose of this paper is to discuss priorities for strengthening Latin American banking, and what indigenous banks must do to compete successfully in domestic and international markets. The paper has been organized in the following way: The first part deals with handicaps imposed on Latin Banks by macroeconomic instability and institutional weaknesses. This section opens the way for a subsequent discussion of policy priorities to overcome current competitive handicaps. Since policy prescriptions usually serve conflicting objectives, the last sections discusses some main conflicts among financial policies and the way to resolve them.

Universidad de
SanAndrés

The context for Latin American banking

Economic instability has been a major handicap for the development of strong banking systems in Latin America. Most countries have a history of chronic high inflation, and some have had serious episodes of hyperinflation. Inflation is inimical to financial development, since the real return on deposits (its nominal return adjusted by inflation) becomes highly volatile, making depositors prefer more stable financial centers. Inflation has been a direct consequence of fiscal deficits. Exchange rate crisis and outbursts of inflation usually occur when foreign financing for fiscal deficits dries up and fiscal imbalances have to be monetized.

Volatility of short term capital movements is a key source of economic instability. Latin America financial systems are increasingly dependent on the conditions of world financial markets. Periods of low interest rates and plentiful liquidity in international markets are associated with strong capital inflows, which produce rapid credit growth and economic expansion. Capital inflows are quickly followed by current account deficits until conditions in foreign financial markets change and short term capital flows back to money centers. In some cases the reversal of capital flows may be triggered by, and in most cases is accelerated by, domestic political developments. This is usually known as the "boom and bust cycle". At the beginning of the cycle, the real return on banks deposits is very high, both in terms of domestic inflation as well as in terms of foreign currencies (since the exchange rate appreciates during the capital inflow phase). Bank deposits and credit grow rapidly, fueling economic expansion and current account deficits. The capital flight phase is characterized by exchange rate depreciation, inflation and credit contraction, and deposits are usually wiped out in terms of both domestic inflation and foreign currencies.

The boom and bust cycle creates special problems for the domestic banking industry. During the expansion phase, credit grows too fast, which is inimical to sound risk evaluation and therefore to healthy growth of bank assets. With abundant credit available, credit quality follow-ups also become difficult. In this phase, banks compete intensely for lending and often they don't check out clients thoroughly before increasing credit lines. But if banks required clients to be current on payments before rolling over amortization and interest payments, even bad borrowers would still manage to be current on payments

Universidad de San Andrés

through new borrowing elsewhere.[1] When the credit "bubble" ends, and banks try to get loans serviced simultaneously, hidden problems in credit allocation and follow-ups can surface abruptly.

Another special problem to the Latin banking industry originates in wide fluctuations of relative prices associated with the boom and bust cycle. Frequent changes in relative prices transform can quickly transform prosperous sectors into problem sectors (and vice versa). Since banks usually share the losses but not the windfalls of their clients, defaults increase on average with the volatility of capital flows and relative prices in the economy.

In addition to these macroeconomic restrictions, Latin American banks face other restrictions more specific to the industry. An important one is the common presence of government-owned banks that operate under an implicit government guarantee and compete aggressively for deposits with private banks. Their activities distort the market, increasing the cost of deposits while financing public sector deficits and lending carelessly to the private sector. Their politically motivated lending policies also contribute to quasi-fiscal deficits and insolvent governments in the medium term.

Another common handicap for domestic banking systems is the presence of weak regulatory and supervisory frameworks which subject sound private banks to great competitive disadvantage for several reasons. Weak entry policies, lack of supervision on related lending, and political interference in resolving problem cases, encourage risk taking and fraud. The activities of adventurous bankers increase in the short run the cost of a common pool of deposits. Subsequently, bank failures and consequent banking crises can produce permanent damage to depositors' confidence, from which the industry may take years to recover.

The inability of Latin Governments to support banking systems in times of (systemic) liquidity crises also hamper their development. Fiscal and banking crises usually coincide because both are triggered or simultaneously aggravated by a reversal of capital flows. When domestic banks need liquidity support the most, governments (short of foreign reserves or unable to raise funding in foreign capital markets) may be least able to provide it.

[1] Credit bureaus are either non-existing or very weak in most Latin countries, which allows borrowers to borrow from different sources simultaneously.

Universidad de San Andrés

Banking and fiscal difficulties tend to reinforce each other: If depositors perceive that the likelihood of government support to banks is small, any incipient run on deposits may become systemic. On the other hand, credit crunches associated with abrupt outflows of deposits affect economic activity and government revenues, exacerbating fiscal weakness and the governments' inability to support the banking system.

Finally, poor management of earlier banking crisis has damaged Latin banking systems. When recklessness on the part of bankers was allowed to go unpunished, a perverse precedent was set that aggravates the moral hazard problem and the regulatory and supervisory requirements inherent to any banking system. When individual bank failures were allowed to become bank runs, and governments did not protect depositors from inflation or outright default, depositors confidence was damaged and the risk premium on domestic banks increased permanently.[2]

The starting point

The problems described above do not affect all Latin banking systems to the same degree. But they are an stylized presentation of most common restrictions to Latin Banking. The cumulative effect of the macro and institutional weaknesses has contributed to deposit and lending rates that are well above the rates prevailing in international markets.

The degree of financial intermediation through Latin banks is much lower (in proportion to GDP) than in industrial countries. Inflation, legal insecurity and tax advantages has encouraged wealthy depositors to move their funds to foreign financial centers. This is not a new phenomena, and it varies from country to country with the intensity of the problems described in the previous section A more recent development however is the loss of prime creditors to foreign financial centers. The openness of border capital flows, allows prime domestic borrowers to place their own paper directly in international markets and to access low cost lines of credit channeled to the domestic market by resident foreign banks.

[2] The inability of Governments to provide liquidity support mostly affects local private banks. Foreign banks benefit from the perceived support from their main offices and, indirectly, from their own country governments.

Universidad de San Andrés

Consequently, Latin banking systems in general, and indigenous banks in particular, are increasingly deprived of business from prime depositors and borrowers. Their intermediation, which is usually conducted at high deposit and lending rates, is limited to small savers and more risky creditors, such as medium and small enterprises, consumers, and the government. Banks are usually blamed for inefficiency and abusive interest charges, but to an important extent lending rates merely reflect higher deposit rates and the (higher) costs and risks associated with lending to small and medium borrowers.[3]

The problems faced by Latin banking systems seriously limit the scope of their banking business and impede their healthy development. Moreover, indigenous banks may be subject to unbearable competition if, while subject to hostile macro and micro environments, capital flows are unrestricted (facilitating competition from financial centers), and foreign banks are allowed to establish themselves in local markets.

This paper attempts to set out the preconditions for Latin banking systems to compete successfully in global financial markets. And for indigenous banks to participate in that development. Projecting current developments into the future, there are potentially two undesired scenarios. The first could be characterized by maintenance of hostile macroeconomic and institutional conditions and continued restrictions on the capital account and on the establishment of foreign banks in domestic markets. This scenario is undesirable because the trend toward globalization and establishment of foreign banks in domestic markets is to the benefit of both depositors and borrowers and therefore should not be prevented.

Universidad de SanAndrés

A second scenario could be characterized by maintenance or insufficient progress in removing hostile macro and institutional conditions while the capital movements are unrestricted and foreign banks are allowed entry in domestic markets. This scenario would most likely keep prime banking businesses off-shore and result in a major takeover of domestic banks by foreign ones. This is also an undesirable scenario because the banking

[3] Discriminatory taxation and non-remunerated reserve requirements are other explanatory reasons for high lending rates usually found in Latin America. Inefficiency is also present and there is a large room for improvement here. However, inefficiency is more related to the transaction part of banks, and improvement in this area should be reflected mainly on reduced fees for services.

business will continue to be weak and costly, and the principle of competing on equal footing would not be respected.

A preferable scenario is characterized by a quick improvement of current macro and institutional conditions, a complete opening of the capital account, and access of foreign banks to domestic markets. One of the basic premises of this paper is that current macro and institutional conditions affect mostly indigenous banks, and that the removal of these restrictions is the best way to develop the domestic banking sector on the basis of equal opportunities for local and foreign banking. If indigenous banks are given the opportunity to compete on a level playing field, they will compete successfully, as they have done in several emerging markets.

Priorities for Macroeconomic Policies

Achieving low and stable inflation rates is a top priority for strengthening Latin banking and it is a precondition for attracting deposits at a low cost by international standards. Temporary low inflation rates are not sufficient however. A perception of sustainability is key to increasing low cost funding on a permanent basis. There may be political reasons that make permanent stability difficult to achieve in Latin America. While attempting to reduce inflation on a permanent basis, some countries have decided to reduce depositors skepticism (on the prospects for low and stable inflation rates) by introducing indexation or allowing dollarization of banking instruments.

Universidad de San Andrés

The worst scenario for Latin banking systems is one in which inflation remains high and unstable and there are no inflation or exchange rate hedges exist to protect depositors. Introducing indexation or dollarization without reducing and stabilizing inflation rates is better, but not sufficient to overcome current handicaps. The immediate objective of financial policy in Latin countries must be to achieve low inflation as soon as possible , but to maintain (or introduce) indexation or dollarization schemes until depositors are convinced of the sustainability of the stabilization process.[4]

---

[4] It is outside the scope of this paper to discuss the relative merits of indexation and dollarization. Indexation is more coherent with a flexible exchange rate system while dollarization is coherent with fixed exchange rates. Any discussion would thus have to focus on the relative merits of fixed vs. flexible exchange rates.

Avoiding the disruptive effects of volatile capital flows must be another major objective of macroeconomic policy. (The problems associated with the boom and bust cycle were already described on page 3). This issue however is a source of great controversy. Some argue that preventing short term capital inflows is impossible. Others emphasize the distortionary effects of capital controls, particularly when they aim to prevent capital outflows.

I believe that avoiding the disruptive effects of short term capital flows is possible and can be done without applying capital controls. To that end, fiscal policy must play a primary role, accumulating fiscal surpluses in times of capital inflows. Moreover, exceptional liquidity requirements on bank deposits and other short term foreign liabilities should also be used to prevent too rapid increases in credit.[5]

Fiscal policy must play a primary role in achieving a proper macroeconomic framework. The ability to reduce inflation permanently requires sustainable fiscal balances. When countries find easy financing (either through borrowing or privatization), stabilization may be achieved without fiscal consolidation. The stabilization effort may not be sustainable however, and it will be threatened as soon as financing dries up.

Fiscal policy also serves a critical antyciclical function in Latin countries in compensating for the abrupt (and unsustainable) effects on aggregate demand of short term capital inflows. Moreover, during banking crises, government's ability to support banking systems without monetary expansion or currency devaluation, is decisive in preventing bank failures from developing into systemic runs on deposits, and permanently damaging the banking industry.

The prospects for strengthening banking systems in Latin America are therefore intimately related to prudent fiscal policies and Latin Bankers must fully realize this relationship. Fiscal deficits may not be that easy to identify when governments use "creative accounting" or when they are hidden in the accounts of central banks, state governments or even government-owned banks. Their potential damage may also be difficult to imagine when inflation is low and foreign financing is plentiful. It is also a common phenomena that financing the government at profitable rates becomes an important part of

[5] Excess liquidity requirements on banks' liabilities may not be necessary if existing capital asset ratios are binding.

Universidad de SanAndrés

local banks' business. A major conflict of interest is then created between the short term and long term interest of the banking industry.

The importance of achieving stability through fiscal "overkill" cannot be exaggerated in Latin America. After decades of inflation, deposits wipe outs, bank failures, and legal insecurity, local banking systems face overwhelming handicaps in open competition with international financial centers. A stable macroeconomic framework and a solvent supportive government are the most important weapons at hand to reduce the gap.

Priorities for industry specific policies

Moral hazard problems are inherent to the banking industry. Preventing their consequences is a major challenge even for industrial countries. It is a very complex problem that requires a whole set of well functioning institutions. Rather than identifying a few priorities, it is necessary to recognize special institutional weaknesses in Latin America and recommend achievement of minimum standards in all institutions simultaneously in the areas of regulation, supervision, crisis management and privatization .[6]

Regulation must be modernized in the following areas:

> **Entry standards** should aim at allowing competition through new entrants that are "fit and proper" regarding their professional experience and clean records. It is also necessary to secure that any existing bank is not bought through leveraged buy-outs. It is also important that entry decisions are free of political intervention.
>
> **Minimum capital requirements** are required to limit the moral hazard risk of the industry. The minimum requirements must be more stringent than in industrial countries to compensate for higher risks and weaker supervision in Latin America.
>
> **Asset classification rules** are necessary to avoid improper accounting of problem loans. Rules must be designed to classify loans based on

[6] For a more detailed discussion of regulatory and supervisory issues, see the papers of Aristóbulo de Juan and Ruth de Krivoy referred to in the bibliographic notes.

objective criteria that capture the repayment capacity of the borrower, thus allowing supervisors to demand additional provisions on loans that are formally current (through continuous rollovers) but are in fact problem loans.

Limits to related lending are also a must in Latin America, where the idea of using the resources of banks for the benefit of bankers is so common.

. **Appropriate enforcement powers** should be granted to supervisory agencies to secure compliance with regulations. In addition to being able to impose provisions or establishing fines, supervisors should be able to enforce recapitalization, removal of management, intervention and license cancellation in order to correct bank problems early on.

Modernizing regulatory legislation should be made a priority for those Latin American countries that have not yet done so. They should select the best regulatory practices of industrial countries, concentrate reform efforts in the most important areas, adapt foreign regulatory norms and institutions in the simplest possible way, and make them more stringent.

Supervision is essential for effective regulation. Good supervision is a scarce resource worldwide however, and in Latin America in particular. There is also a need to avoid overburdening banks with costly supervision. To improve the quality of supervision without increasing the costs of the banking systems, supervisory agencies in Latin America should consider the following recommendations:

Universidad de
SanAndrés

1) Make external auditors and bank rating agencies work for the supervisory agency. For that purpose collect a "supervision fee" from banks to finance direct selection and hiring of auditors and rating companies.
2) Improve the human capital and remuneration of supervisors. Train them to concentrate their effort exclusively in inspecting the quality of loans and related lending. Rely on external auditors for supervision of other regulations. Use rating agencies for global evaluation of banks.
3) Enforce the development of credit bureaus on a compulsory basis for at least all banks and financial companies. Comprehensive information about clients indebtedness is a public good that will help banks to asses credit risk, but will also facilitate the work of supervisors.

4) Require large and medium banks to go public for at least 30 percent of their capital. A bank's share price would be an important bellwether of its financial situation.
5) Small banks are always costly to supervise, and ways must be found to reduce the need for inspections. One way would be to impose on them more stringent capital requirements, so that small banks would have to grow through securitizable assets. The market value or acceptance a bank's securitized assets could be used overtime as an indicator for allowing it to operate with capital asset ratios of a full bank.

In any case supervisory agencies should have the political support they need to enforce regulation. There has been much discussion about the need for an independent supervisory agency. Others support the idea of a supervisory agency inside an independent Central Bank. Formal independence does not guarantee substantive independence in the Latin American context, however. What is of the essence is a major political decision not to interfere with regulation and supervision of the banking industry. This is not easy to achieve when business interests are too close to politics.

Crisis Management. Bank failures are sometimes unavoidable and it is necessary that central banks and/or supervisory agencies have the tools to prevent them from developing into deposit runs. It is also important that the capacity exists to abort incipient systemic crisis originated in macroeconomic shocks. Proper management of bank failures are necessary to minimize fiscal losses but also to avoid the moral hazard problem of the industry. Avoiding systemic crisis is imperative for preventing recessions and lasting damages to depositors' confidence.

Universidad de SanAndrés

The (sometimes controversial) institutions used to manage banking crisis are liquidity requirements, the lender of last resort function, distress assistance, guarantees of deposits and recapitalization schemes. Proper functioning of these institutions is particularly relevant for private local banks, as government-owned banks enjoy the implicit support of governments and foreign banks are perceived as fully supported by their parent banks.

Liquidity requirements are usually used for multiple purposes. They have been rightly criticized when they are non-remunerated and used as a source of cheap financing for fiscal deficits and as an implicit taxation of the banking system. This criticism is specially strong in

contexts of high inflation, because in that case the implicit taxation is higher, and the incentives for intermediation through other markets are very distortionary. They have also been criticized when used to limit banks' exposure, since capital asset ratios are a better instrument for that purpose.

The position of this paper is that liquidity requirements should be established primarily to guarantee that the banking system as a whole has a minimum of liquidity to face potential systemic problems originated in domestic or foreign shocks. For that purpose liquid assets must be invested abroad, either directly by banks or through the Central Bank. What is the appropriate liquidity requirement may differ from country to country, since the probability of systemic liquidity crisis is not the same in all countries.

A second (but temporary) objective of liquidity requirements should be to control the speed of credit growth when capital inflows are abrupt. In this case it may be justified that the (excess) liquidity requirements are non-remunerated.

The lender of last resort function, must be designed exclusively for transitory liquidity support. But it is usually difficult for central bankers to distinguish a transitory liquidity problem from a solvency one.[7] For this reason central banks should give liquidity support only through temporary releases of liquidity requirements and rediscount facilities guaranteed only by top quality assets. What constitutes top quality assets should be objectively defined to clearly differentiate between liquidity assistance and distress support.

Distress Assistance. When a bank has difficulties that go beyond a temporary liquidity problem, the authorities face tough choices:

To give additional support to the bank while demanding capitalization;
To give additional support but removing the owners and management from control while looking for a new owner;
To suspend the entity's operations while a new owner is found;
To close the entity.

[7] This difficulty is usually related to poor prior supervision.

The last two alternatives are seldom chosen for big banks whose closure could trigger a domino effect. They are more commonly chosen for small entities. One major problem for central bankers is where to draw the line between banks that are left on their own and those to be supported. The choice between options one and two is also a difficult one: If the entity is bankrupt and the owners are left in control because the supervisory agency does not have a precise diagnosis, fiscal losses could worsen significantly. If owners are removed from control, the question arises as to who manages the bank until a buyer is found. Choices are tough enough to recall the importance of preventive action through supervision and early remedial measures But anyway central banks should be prepared to apply the following guidelines in case of failures:

Have a (hidden) definition about what to do with failing banks.

If the decision is to support big banks, have a clear idea which banks are too big to fall and which aren't.

Treat small banks differently: Allow them to operate only with higher capital asset ratios.

Implement a legislative framework that provides the supervisory agency with broad powers to intervene, manage and liquidate banks and banks' assets; and

Do not bail bankrupt owners out through permissive capitalization schemes or other means.

Universidad de San Andrés

Guarantee of deposits is another important, if controversial institution. Experiences with full government guarantee of deposits may have encouraged irresponsible banking practices. Defenders of the guarantee argue, however, that its existence does not lead to serious moral hazard problems. The character of bankers allowed to operate, quality of supervision and treatment of bankrupt bankers in case of failures, are found to be more important determinants of bankers behavior. Moreover deposit guarantees are defended as a way to achieve level playing competition between local banks and foreign

banks. The third argument is a practical one: if potential domino effects would protect big banks from closing (and an implicit government guarantee of deposits would therefore exist for them), small banks would be at competitive disadvantage if formal guarantee is not established. For these reasons regulatory practices are moving in the direction of limiting deposit guarantees to small depositors, which is an acceptable compromise.

There are however two remaining issues to resolve: how the deposit guarantee will be funded and how the central bank (or other responsible institution) will fund losses incurred while supporting banks that are too big to fall?.[8] It is in principle sustainable that the industry should bear its own costs. If the industry has to pay beyond what competing banks in financial centers are made to pay, its competitiveness will be affected. The domestic banking industry should therefore pay insurance premiums similar to premiums paid by competing banking systems, leaving to the government the burden of exceptional costs that originated from (earlier or current) inappropriate macroeconomic and industry specific frameworks.

Recapitalization schemes are a necessary complement when owners do not want to capitalize. To be successful however, government supported-recapitalization schemes have to be implemented with new owners who are "fit and proper" and risk their own capital.

Privatization of government owned banks is key to banking reform in Latin America. In the process of privatization, governments should not grant privileges that would compromise fair competition. It is also important to maintain the requirement for new owners to be fit and proper and risk their own capital.

Major Conflicting Objectives and Their Resolution

[8] It would have more disciplinary effects to make large depositors pay for the failure of large banks (as well as in the case of small banks). But to do so would require that large deposits are not honored from the early moment that rediscount facilities of the Central Bank are exhausted. Such policy may trigger domino effects that Central Banks usually prefer to avoid But it would be a much healthier procedure to follow when the problem is isolated, the rest of the system is sound and the financial position of the government gives ample room of maneuver to support a potential bank run. The importance of good supervision and fiscal solvency come up to surface again

Universidad de San Andrés

Competition vs. Concentration.

Raising entry standards, tightening capital asset ratios, and improving supervision may produce a trend toward concentration in Latin American banking that seems inimical to a competitive environment. Concentration is necessary however, to face the competition generated by open capital markets and arrival of foreign banks. Liberalization policies, and not the number or the size of banks, is what will determine the degree of competitiveness and potential benefits for borrowers and depositors.

There is a more subtle issue, however, regarding the outlook for small and specialized banks. These banks are intrinsically riskier because their lending tends to be concentrated in particular regions or market segments. When entry policies are permissive, this sector most likely comprehends many banks short of capital and scale, what pushes them to riskier lending (usually known as the adverse selection syndrome). They are also more costly to supervise. And when banking crises develop, they are the weakest part of the system. Central banks usually do not support them because they do not put the system at risk. They tend to flourish and disappear like mushrooms, leaving behind defaulted depositors and major central bank losses.

Small banks can be useful institutions in serving local markets or special market segments. There are however small sound banks which are particularly affected by the perceived risks associated with recurrent crises in this institutional segment. The question is then how to reconcile their potential usefulness with sound banking.

One alternative would be to improve entry requirements for and supervision of small banks. This approach, while desirable, is not feasible given the limitations of most supervisory agencies in Latin America. A second alternative would be to have a different regulatory regime for small banks, basically characterized by a more stringent capital asset ratio. This regime would not prevent the development of good regional or specialized lending but would change its nature for the better. A possible outcome would be the development of associative agreements between small banks and larger institutions. Another desirable outcome could be sound lending not limited by the capital asset ratio if it qualifies to be securitized or to be sold in the market to large institutions. Pricing and market acceptance of small banks'

assets would show the quality of their lending, what would be later on the best possible indicator for "graduating" bankers.

Liberalization vs. Financial Stability

.A liberalized capital account is usually blamed for encouraging volatile capital flows and of causing boom and bust cycles. For this reason, it is argued that the liberalization of controls on capital flows to emerging countries should be managed gradually, allowing first long term capital movements and postponing short term ones. Liberalization is seen as inimical to financial stability.

Fixed exchange rates and dollarization of banking assets are also frequently discouraged. It is argued that they are also likely to encourage volatile capital flows and overvaluation. They are also thought to impede support of banking systems during financial crises because dollarized banking systems would require a lender of last resort with sufficient foreign reserves, whereas foreign reserves would be committed to supporting the fixed exchange rate regime.[9] Dollarization and fixed exchange rates are thus seen to hamper the government's ability to act as lender of last resort.

Liberalization of capital accounts will, however, benefit both borrowers and depositors. Dollarization (or indexation) schemes will also help to overcome depositors' fears about the sustainability of financial stability, contributing therefore to a more rapid reduction of the cost of funding local banks. We are therefore in the presence of conflicting objectives.

The resolution of these conflicts based on maintaining controls and exchange rate uncertainty, is not satisfactory. They could be argued as a first best solution only if there were no other (more efficient) instruments available to neutralize the undesired effects of volatile capital flows and to have a reliable lender of last resort.

Fiscal policy and liquidity requirements are much more efficient instruments to resolve the conflict. A solvent government, characterized by a low debt concentrated in medium and long term instruments, fiscal equilibrium, available credit lines with multilateral organizations and international reserves

[9] For an illustration on these views, see the paper of Jeffrey Sachs cited in the bibliographic section.

Universidad de SanAndrés

commensurate to the short term liabilities of the central bank, would have ample room to maneuver as lender of last resort in any financial crisis, especially if banks are required to have liquidity requirements invested abroad.

A prudent anticyclical policy would also be a superior instrument to compensate for undesirable effects of volatile capital flows. In this case it may be convenient to support fiscal policy with temporary (excess) liquidity requirements to smooth out credit growth.[10]

Summary and Conclusion

This paper has explored the conditions for strengthening Latin American banking in a context of open capital markets and level playing field competition between foreign and domestic banks. Macroeconomic instability and institutional weaknesses are seen as great handicaps for Latin banking competitiveness and for domestic banks in particular.

Improvements in the macroeconomic framework are a priority to attract deposits at competitive costs. To that end, prudent fiscal policies and (temporary) sterilization of short term capital flows are seen as key policy instruments to achieve sustainable macroeconomic stability.

QUAERERE VERUM Universidad de SanAndrés

Better regulation and supervision are also key to strengthening Latin banking. Sound banks are at a clear competitive disadvantage when unsound banking practices are allowed and banking failures can develop into banking crises with lasting consequences.

The paper recommends a set of macroeconomic and institutional measures that allow for some trade-offs. For example, the need for liquidity requirements would depend on the quality of supervision and the strength of the government's fiscal position. However, the relation among the suggested policies is basically one of high complementarity:

Macroeconomic stability without fiscal consolidation is unsustainable.

[10] Sterilization policies are frequently criticized for being self defeating and producing cuasi-fiscal deficits. This critic is pertinent when sterilization policies are made through liquid government paper that carries high yields. This critic does not apply when sterilization is performed through liquidity requirements that carry an implicit tax which magnitude will depend on the degree of remuneration of those requirements.

Regulation without strong supervision is useless.
Crisis management institutions without fiscal solvency are unrealistic.

Strengthening Latin American banking requires therefore decisive and simultaneous action to achieve sustainable macroeconomic stability and strong (industry specific) institutions. The current competitive gap is however very large and the uncontrollable factors that explain that gap are very important. That requires a special effort on controllable factors like macroeconomic policies and institutional reform. The basic conclusion could be summarized saying that the Basle rules for industry regulation are not sufficient for Latin America. And that the Maastrich rules for fiscal behavior aren't either.

Universidad de
SanAndrés

Selected References

De Juan, Aristóbulo: 'The roots of banking crisis: Micro-economic issues and issues of supervision and regulation". Paper prepared for the Conference on Banking Crisis in Latin America. October 6-7, 1995. Washington D.C.

De Juan, Aristóbulo: "False friends in banking reform". Mimeo, September 1995.

De Krivoy, Ruth: "An agenda for banking crisis avoidance in Latin America". Paper prepared For the Conference on Banking Crisis in Latin America. October 6-7, 1995. Washington D.C.

Hausmann, Ricardo and Gavin, Michael: "The roots of banking crisis: the macroeconomic context". Paper prepared for the Conference on Banking Crisis in Latin America. October 6-7, 1995. Washington DC

International Monetary Fund: "International capital markets: developments, prospects and policy issues". Background papers IV, V and VI. Washington D.C., 1995.

Rojas-Suarez, Liliana and Weisbroad, Steven: "Banking crisis in Latin America: Experience and issues". Paper prepared for the Conference on Banking Crisis in Latin America. October 6-7, 1995. Washington D.C.

Rojas-Suarez, Liliana and Weisbroad, Steven: "Managing banking crisis in Latin America: The do's and don'ts of successful bank restructuring programs". Paper prepared for the Conference on Banking Crisis in Latin America. October 6-7, 1995. Washington D.C.

Sachs, Jeffrey: "Alternative approaches to financial crisis in emerging markets". Mimeo, November 1995.

Universidad de San Andrés