EXECUTIVE SUMMARY: DOMESTIC FINANCE AND GLOBAL CAPITAL IN LATIN AMERICA

Stephen Kay and Elizabeth McQuerry
Federal Reserve Bank of Atlanta

Financial liberalization is among the most pressing goals for policymakers in Latin America today as policies aimed at expanding, diversifying, and modernizing financial services foster greater participation in the global economy. However, liberalization also presents new dilemmas. Lower barriers to entry have attracted much-needed foreign capital but have also introduced new uncertainty and volatility. Moreover, existing weaknesses in some financial systems have resulted in costly bank bailouts. The banking sector is especially vulnerable as economies are opened to international financial markets, thereby meshing local and international markets to unprecedented degrees. These linkages have brought about increased integration in the Western Hemisphere, thereby ensuring that both the process and the results of financial liberalization in Latin America have important implications for U.S. financial markets and the international trade outlook.

A group of regulators, policymakers, bankers, and academics convened in Miami in November 2001 to discuss policy concerns related to the process of opening and developing financial markets in Latin America. Original research was presented that explored theoretical issues related to capital flows and liberalization, banking sector issues, and the workings of financial markets. The conference concluded with a roundtable on monetary and regulatory policy in which distinguished policymakers and academics discussed their experiences in modernizing the region's capital markets as well as their concerns about the process going forward.

Several themes emerged from the day and a half discussion. The overarching linkages between the domestic and international environments were a theme that, to a greater or lesser degree, pervaded every discussion. Other core elements of the discussion were the pace of capital flows and external shocks, concerns about the adequacy of the existing international financial architecture, and variations in existing regulatory frameworks.

The Argentine Crisis

Several of these elements are discussed in keynote speaker Ricardo López-Murphy's evaluation of the crisis in Argentina, which was unraveling quickly at the time of the conference. The former economy minister highlights the causal role of both external and domestic factors. He notes that external shocks like the Russian and Asian crises and the devaluation of the Brazilian *real* had contributed to Argentina's crisis, but he also points to domestic policy, including the failure to reduce public expenditures. Public spending grew 100 percent in the 1990s even though gross domestic product (GDP) grew by only 40 percent. López-Murphy argues that a credible governing coalition, a more favorable external environment, and institutional reform were essential to improving the situation in Argentina.

Liberalization Frameworks

The continuity of capital flows to Latin America is the focus of the paper by Eduardo Fernández-Arias and Ugo Panizza. The authors argue that a series of external shocks in the late 1990s led to a significant and persistent rise in the cost of capital for emerging markets in general and Latin America in particular. Since regional output growth and private net flows are positively correlated, volatile capital flows are associated with volatile growth patterns. While this analysis emphasizes the negative impact of dependence on external capital flows, the current wave of reform of the international financial architecture is based on an alternative explanation that stresses the role of moral hazard. According to this view, moral hazard is caused by implicit government guarantees to the banking sector (or the private sector more generally) under conditions of poor domestic financial supervision. Market discipline does not function properly under these conditions because private returns are artificially inflated, exceeding true or social returns. The solution to crises, according to this logic, is to improve regulation, reduce the size and scope of rescue packages, and bail in private investors to make sure that they assume the true risk of their actions. The authors conclude that this solution is not appropriate because it will lead to lower capital flows and possibly greater instability. Instead, they propose that international institutions be redesigned to address the risk of international private flows, suggesting that international institutions with legal powers to regulate and remedy international financial transactions will in the long run provide greater stability.

The question of how much liberalization has occurred is the subject of the paper by Myriam Quispe-Agnoli and Elizabeth McQuerry. The authors develop an Index of Banking Activity as a proxy for evaluating the multifaceted process of financial liberalization (for which a full set of data is not yet available). The findings show a set of diverse experiences in five Latin American countries; these experiences contrasted with the past patterns in more industrialized countries. These findings broadly suggest that initial conditions and the widely varying endowments (both economic and institutional) in each country may be the greatest determinants of outcomes. The index summarizes the fluctuations in performance indicators, covering different aspects of the process of deepening banking activity. The authors provide a unitary framework through which to examine financial developments in Latin America over time that is process-based and not focused on isolated crisis periods.

Banking Sector Questions

Three papers focus on the banking sector in the region. Miguel Kiguel describes the dramatic transformation in the Argentine banking system during the 1990s. The improvement in macroeconomic conditions brought about a surge in deposit growth and a dramatic expansion of the monetary base. At the same time, ownership became more concentrated as many state-owned banks were privatized and foreign banks became prominent players in the local market. By and large, the banking system at the end of the nineties was stronger, larger, more solvent, and had better liquidity indicators. Improved capital and liquidity helped the Argentine banking system face a number of important crises in the 1990s. In fact, the strength of the banking system during the second half of the nineties was one of the key assets of the Argentine economy. Given the transformation of Argentina's banking system, which was widely considered one of the great successes of the country's reforms, Kiguel's analysis is all the more insightful given the crisis that emerged in 2001. Amid a collapse in the currency board and a loss of public confidence in the banking system, and lacking a lender of last resort, the banking system that had proven resilient to crises in the 1990s entered into a severe and unprecedented crisis.

The adequacy of the larger institutional framework in which banks operate is also evaluated. One area of concern is the friction between domestic institutions and international financial regulations. José María Fanelli and Rohinton Medhora's paper explores the areas of weak or improperly functioning institutions in the current framework and their implications for banking sectors in Latin America. The authors present two hypotheses on the relationship between domestic and international institutions. First, the framework regulating financial intermediation in a given economy should not be conceived independently from the developments in international markets and institutions. Second, to make financial crises in developing countries less likely, the emerging international financial architecture must be consistent with the domestic framework and must take into account some key characteristics of developing economies. Chief among these characteristics are the higher volatility of the macroeconomic and financial environment, the underdevelopment of the market structure (imperfections, missing markets, high transactions costs), the weakness of institutions, and the small set of countercyclical instruments at the disposal of authorities. The authors conclude that institution building should be the top priority and that the process should emphasize market creation rather than market liberalization.

The range of reforms through which Latin America's new banking markets were created is evaluated in the paper by Rogério Studart. Overall the process has often been criticized for occurring without adequate regulation and supervision, setting up a poor foundation for the sector that ultimately compounded problems for bankers who were often inexperienced in both credit analysis and in dealing with the complexities of international financial markets. In evaluating the reforms in Argentina, Brazil, Chile, and Mexico, Studart concluded that the devastating effect of the abrupt and deep macroeconomic shocks that have been so common in Latin America in recent years easily overwhelmed the quality of reform in any particular country—even the best regulated and supervised banking sectors cannot cope with such volatility. While the region's banking systems are now potentially more stable thanks to recent reforms, macroeconomic stability and growth remain a precondition for the growth of credit to the private sector and for a sustained reduction of spreads and thus borrowing costs.

The Effects of Financial Crises

The session on financial market questions included two papers focusing on separate but related aspects of market developments. William C. Gruben and John Welch explore some of the financial crisis episodes that have plagued emerging market economies in recent years. The authors note that, since the mid-1990s, emerging market economies have gone through waves of exchange rate crises, and a great deal of attention has been paid to the causes of these crises and their prevention. In their paper, Gruben and Welch argue that more attention must be paid to the various ways in which countries recover after a crisis. Some nations, including Brazil, Mexico, and Korea, have accomplished miraculous turnarounds as a result of strong policy steps while in other nations, such as Russia, luck was probably more important than effective policy. This paper outlines the post-crisis policy steps taken by various nations and evaluates their results. The authors explore Brazil's 1999 devaluation and how it differed from those of Mexico, Thailand, and Korea. A key difference is that financial sector weakness did not trigger Brazil's exchange regime crisis. Furthermore, Brazil lessened the impact of its 1999 devaluation by strengthening the banking system and by taking steps to allow the private sector to hedge against an impending devaluation. The paper concludes that not only banking system weakness but also banking system health affects the options governments have in defending or stabilizing their currency.

The second paper explores the future of Latin America's domestic capital markets. Eduardo Walker and Fernando Lefort examine whether the decline in the region's financial markets is permanent or is a temporary manifestation of current conditions. Walker and Lefort hypothesize that the Asian crisis and its aftermath triggered the recent evolution in financial markets (lower trading volumes, lower market capitalization, and higher cost of capital) and may thus be transitory. They also identified distinct services for which local capital markets may have competitive advantages: short-term liquidity, long-term financing with matching currency, and equity financing for smaller or younger firms. According to the authors, local markets are better at providing these services because of economies of scale, perspective and definition of risk, and informational asymmetries that arise between local and cross-border markets. Also, local capital markets may provide the only way to mitigate the adverse effects of external shocks. The authors argue that Latin American financial markets are still in an early stage of development and do not fully provide these services but can do so in the future. For this to happen, macroeconomic stability and enhanced investor protection probably are the two most important prerequisites.

Policy Dialogue

The conference concluded with a roundtable discussion in which four panelists were asked to comment on a range of issues related to monetary and regulatory policy in an era of global markets, including the implications of the financial integration with regard to regulatory structure, international regulatory coordination and cooperation, and dollarization. Robert A. Eisenbeis led the discussion by Ilan Goldfajn of the Banco Central do Brasil, Liliana Rojas-Suarez of the

Institute for International Economics, Nouriel Roubini of New York University, and Leonardo Villar Gómez of the Banco de la República in Colombia.

Liliana Rojas-Suarez discussed whether improved regulations have also improved the soundness of financial institutions in developing countries. She argued that this is not always the case and noted that the Basle recommendations, which seek to minimize risk-taking activity by banks, have had unintended consequences in the region because they were not designed for emerging markets but rather for industrialized countries with more liquid capital markets that had never lost access to international capital markets. One example of the inappropriateness of the Basle accords is that government debt is considered a safe asset. This is true in the industrialized countries, but it is clearly not the case in countries where governments have defaulted on their obligations.

Ilan Goldfajn commented that while the benefits of global capital are well known, we have not yet begun to fully understand the cost side of the equation. Most of the arguments about the cost of global capital center upon volatility, but he argues that if the problem were just volatility, there are market mechanisms than can cope with it. The real problem is “sudden stops,” which he defines as very large changes in the supply of capital. While large inflows of capital can also be difficult, the real problem occurs when flows drop on the order of 10 percent of GDP from one year to the next, which was the case for Mexico, Asia, Turkey, and Brazil. He argued that dealing with sudden stops requires flexibility and presents the dilemma of how to generate more flexibility while simultaneously maintaining credibility. Goldfajn advocated inflation targeting as a mechanism to allow more flexibility while still maintaining credibility. At the global level, multilateral institutions still have an important role to play because they provide necessary funding during sudden stops. Moral hazard becomes a concern only if the assistance package is badly designed.

Nouriel Roubini focused on the contentious question of crisis resolution—that is, the debate about bail-ins, bailouts, burden sharing, and how to constructively engage the private sector in the process. Private sector involvement is a central issue in crisis resolution because, when a crisis occurs, large external financing gaps (driven both by current account deficits and large capital outflows) emerge, and these gaps have to be met somehow. Roubini discussed a series of parallel questions for crisis resolution. These include how to handle the bigger cases like Turkey, Argentina, and Brazil; evaluating trade-offs between normal and exceptional packages when countries are allowed to borrow very large sums in excess of their IMF quota; and whether private sector involvement should be coercive as opposed to voluntary. Regarding the exchange rate regime, a floating currency is the best option for emerging markets with openness to international capital markets except in those countries that have an intrinsic foundation for dollarization, according to Roubini.

Leonardo Villar Gómez evaluated some of the problems for monetary policy in Latin America. Large swings in foreign capital flows and the limited credibility in the ability of Latin American central banks to keep inflation under control mean that central banks have limited autonomy in an operational sense. The main challenge for Latin American central banks is to enhance the credibility in domestic currencies. Villar asserted that inflation targeting can be a key element in this strategy because fostering low rates of inflation is a prerequisite for a countercyclical policy strategy. Developing such mechanisms is necessary, according to Villar, to balance out the procyclical behavior of domestic interest rates in Latin American countries produced by the procyclicality of foreign capital flows.

The research presentations and discussion from the conference highlighted the complex and daunting challenges facing policymakers in Latin America today. At the same time, the views expressed also reaffirmed the critical role of previous reforms in establishing a more solid foundation for Latin America's financial markets to grow in the future. Although the remaining challenges (such as volatility, shallow markets, low policy credibility, and incomplete regulations) are indeed serious, there also appears to be progress in many countries toward diminishing these obstacles.

The discussion and exchange of ideas presented during the conference, which are now available to a broader audience, are intended as a resource for other policymakers and scholars to draw from in future learning and collaboration.