ROUNDTABLE COMMENTS ON MONETARY AND REGULATORY POLICY IN AN ERA OF GLOBAL MARKETS

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During the conference we have heard a lot of stress placed on the importance of adequate regulation and supervision for stability of the banking system. We have also been hearing a continuous reference to the appropriateness of the exchange rate regime and how it affects banking sector stability. And finally, there has been a lot of discussion of the particular risks facing banks in Latin America from domestic, macro, and political shocks, as well as external shocks. What I want to do is to tie all this together, as well as to bring in the role of the multilaterals as my last point, by addressing three issues.

First, related to the question of financial integration, I want to ask, What is the potential role of foreign banks in Latin America? Second, related to the issue of financial integration and moral hazard, I want to examine how effective, or how important, the adoption of international regulations like the Basle Committee's have been for the Latin American banking system. And, finally, to pull everything together, I want to connect the discussion between exchange rate regimes and banking regulations.

First, concerning the role of foreign banks: This issue is so important in the question of financial market integration. It's not just a question of whether you have access but also about the institutions that make up the global system. This morning I heard a number of comments about foreign banks—some in favor and some against. From my perspective, I am going to focus on only one role, which is that the presence of foreign banks in emerging market countries allows regulatory tools to work. I think this is extremely beneficial for the region even though very few people focus on it.

Let me explain my point. Suppose that you have all the standards in the world: the right accounting, the right regulations and supervision, everything in place. However, during most of the nineties, there was a fundamental reason why the regulatory framework could not work well. And the reason is the enormous wealth concentration that used to exist between the financial and the real economy. This still exists in many countries, but in the early nineties and certainly in the eighties, there was an enormous wealth concentration. Now, in a situation like that, regulatory tools like the capital-to-asset ratio simply have no meaning because accounting capital does not reveal at all the true value of capital. It is very easy to transfer capital from the real to the financial sector, especially because the activities of the real sector are beyond the purview of supervisors in the financial sector.

So you have many crises, like the Tequila Crisis and the Korea Crisis. However, if you examine the banking situation in terms of risk-weighted capital as a ratio, you see that they were very well capitalized at the time of the crisis. In fact, in 1994, just before the Tequila Crisis, Mexico was promoted to membership in the Organisation for Economic Co-operation and Development (OECD), and one reason was because it met all of the requirements. But then the crisis came. Afterwards, foreign banks began to enter the market more, thereby breaking the direct relationship between domestic ownership of the real sector and the financial market. Here the role of supervision and regulation becomes relevant because now there is an incentive in the domestic banking system to hold true capital as opposed to accounting capital.

With respect to financial integration, the question becomes whether improved regulations have strengthened bank soundness. This is a very important issue, especially for institutions like the Federal Reserve Bank of Atlanta as well as the multilateral organizations. The International Monetary Fund (IMF) has a unit called the monetary affairs department whose basic objective in life has been to check whether all the principal recommendations of the Basle Committee, that is, the core principles of banking supervision, are implemented in a particular country. And to this they give checks: yes, yes, yes, no, no, improve here, improve there, etc. Has this been the best policy? Has it had any positive impact? Well, the concept is correct. The Basle recommendations are basically to try to minimize risk-taking activity by banks. But these recommendations assume a number of preconditions. First, they were not designed for emerging markets but for industrial countries that never lost access to international capital markets. Second, they were designed for countries that have liquid capital markets, which are even more important than developed capital markets.

If you meet those two conditions, then there is no problem and the Basle recommendations are going to work well. But what happens if you don't meet those conditions and you apply the Basle standards? I am going to give you two examples. The first has to do with the well-known claim that banks are not lending to the private sector these days. This is a very well-known piece of information in Latin America. Banks are not lending, but people rarely draw the connection with regulation.

As you can see from Chart 1, this connection exists. Here you see the amount of government bonds held by the banks during the eighties and nineties. The horizontal axis shows the proportion of government paper held by the banks in the nineties while the vertical axis plots the proportion for the eighties. Remember that in the late eighties and early nineties one of the most important purposes of financial liberalization was to try to eliminate government intervention in the banking system. This of course depends on how you measure and how you define intervention but this charts shows a forty-five degree line demonstrating that the banks held even more government debt in the nineties than in the eighties.

Chart 2 is also telling as it shows that banks don't lend to the private sector during bad economic times. In good times, of course, banks lend to everybody, but that's not the problem. In bad times, which are the recessions, banks acquire greater amounts of government debt. Here you see this phenomenon in two crisis countries, Argentina and Turkey, but this is true for all emerging market countries. The red line shows the increasing proportions of government claims into the banks even as the recession worsened.

Finally, government debt held by banks presents another consideration. One would think that buying government debt would improve the soundness of the bank, therefore minimizing the risk. This is not necessarily true. Argentina and Turkey are again the best examples to make my point. Chart 3 shows that banks hold more government debt as the spreads increase. Thus, the riskier government paper becomes, the more there is in the hands of the banks. Why? This is due to a very simple reason. The Basle committee, when it first designed the rules for OECD countries, created a zero-risk weight recommendation for government debt. Why? Because government paper is a safe asset in industrial countries. But even though government debt is a risky asset in emerging markets, the same recommendation is applied there. The problem is not with the Basle Committee but with the adaptation of this rule by emerging-market governments as it is very convenient for them to provide an incentive for financing their deficits. This means that when there is recession, banks are not going to lend to the private sector. Why? If you lend to the private sector, the risk-weight for the capital-to-asset ratio is 100 percent. In good times, this doesn't matter so much, but during recessions the banks are definitely going to choose the 0 percent weight over 100 percent. The incentive is there.

Let me give you another example. We all talk about the short maturity structure that exists in emerging markets. Let's now look at how regulations influence the term structure. From the industrial country perspective, the issue is very simple: you are a bank in an OECD country and you are lending to a bank in a non-OECD country. In this case, the shorter the maturity, the safer the risk. Why is this? Well, if I lend for one day, the probability of getting paid back is better than if I lend for a month, right? This is obvious. The only problem, as Table 1 shows, is that more than 50 percent of loans from banks in OECD countries to banks in emerging markets are less that one year long in maturity because of this structure. Again, the regulation tells you, that if you extend a loan for over a year you charge 100 percent risk-weight. If you lend for less that year, you only charge 20 percent.

This is also an issue for the domestic banks that are on the receiving end of these short-term loans because institutions like the IMF and the World Bank tell the banking system regulators that they must avoid maturity mismatch like this. In turn, this situation encourages local banks to only lend short term because, otherwise, you are going to have a maturity mismatch and the local supervisors are going to tell you to stop.

As you can see, these factors have important implications for the role of the international organization. These institutions apply standards to countries that, in principle, are sound, but the countries do not have the conditions to perform well. I am not arguing that we forget about applying the correct standards. Rather, I am saying that these are not the right standards. This is true in Latin America, in particular, but emerging-market countries in general face these constraints. And it is the role of the multilateral organization to identify the best standards, rather than simply imposing what is good in industrial countries.

This brings me to the last issue that I want to discuss. How can we connect the discussion between the exchange rate regimes and bank regulations? It is very interesting to me to see how people talk about exchange rates on the one hand and bank regulations on the other. To me, it's the same thing. They are inextricably linked.

I think that the connection between these two issues is the pricing of risk. In order to explain this, let me make a reference to deposit insurance—something with which everyone is already familiar. Nobody doubts that governments must charge for deposit insurance; it cannot be free. The government charges a premium to the banks in order to accumulate the resources for the deposit insurance. This is not controversial. However, many people tend to think differently when we move to the discussion of the exchange rate regime. If the government fixes the exchange rate, it is offering a guarantee which is effectively a different type of insurance for the banking system. In addition, the government is providing an incentive to make certain kinds of loans. If a bank lends to the nontradable sector, it expects to receive a higher rate of interest, but at the same time, the bank is protected against the adverse impact that external shocks would have on the nontradable sector.

The issue is not really what kind of exchange regime you have, but, rather, the fact that the exchange regime sets up a number of conditions that have to be priced-in when extending loans to the private sector. And banks are not charged for the insurance they receive from a fixed exchange rate system.

I always think it's funny when people talk about unexpected shocks because there is nothing more expected than a shock in Latin America. They keep coming, over and over again. In very closed economies, you are going to have terms of trade shocks all the time. You loose access to international capital markets over and over again. It is obvious that these shocks will reoccur. We also know that these shocks will bring an adjustment through the depreciation of the real exchange rate. This adjustment hurts the nontradable sector, making it more risky. From my perspective, this means that banks need to provision ex ante for expected risks.

Some people may then ask, What can you do with the nontradable sector? Of course, this is not very politically correct. Actually, it is correct but not politically correct. And that is why many governments offer a fixed exchange rate system. They know what is going to happen. The motivation is more a social reason than an economic reason, but it brings other costs. Don't risk the banking sector. It's a fiscal issue.

Chart 1: Government Debt 1980s against 1990s

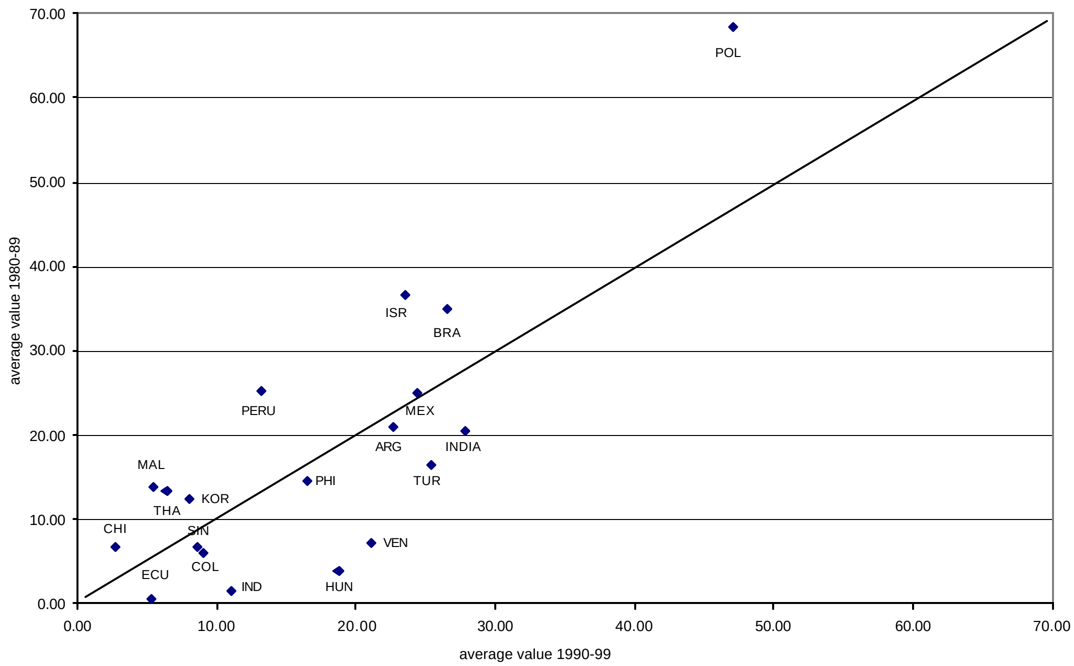
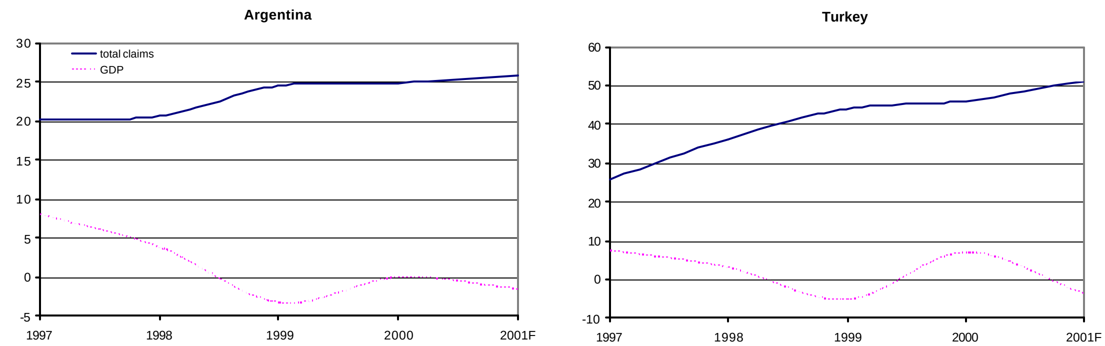


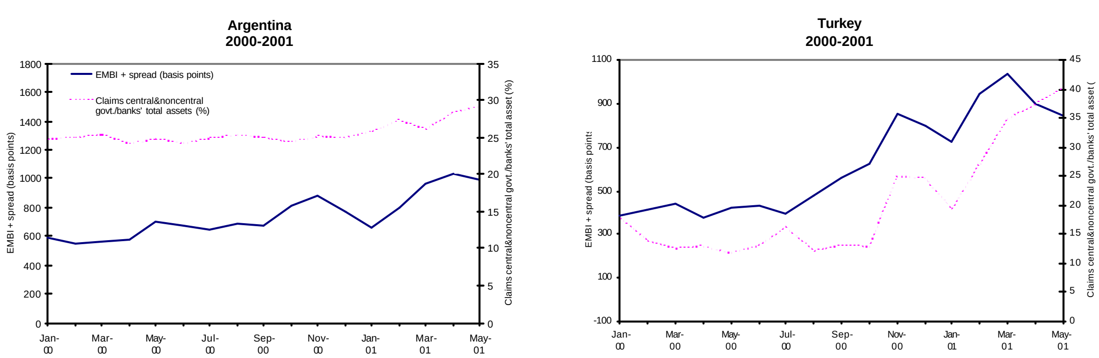
CHART 2: Economic Activity and Banks' Claims on Government as Percentage of Total Assets



Note: "F" indicates consensus forecast. The 2001 data for total claims on government correspond to June for Argentina and May for Turkey

Source: IMF (2001) *International Financial Statistics*; World Bank (2001) World Development Indicators and private sector forecasts

CHART 3: Sovereign Risk and Banks' Claims on Government as Percentage of Total Assets



Source: Bloomberg and IMF (2001) *International Financial Statistics*

Table 1: Consolidated Cross-Border Claims of BIS Reporting Banks on Individual Countries, End of March 2001

	Total (millions of US $)	Millions of US $	Percentage of total claims
Argentina	65,956	36,916	55.97
Bolivia	1,430	812	56.78
Brazil	67,777	33,554	49.51
Chile	22,340	9,485	42.46
Colombia	11,729	4,319	36.82
Ecuador	1,509	861	57.06
Mexico	68,931	26,305	38.16
Peru	13,035	8,546	65.56
Venezuela	12,668	4,661	36.79
China	56,029	18,048	32.21
China, Hong Kong	111,610	66,948	59.98
Chinese Taipei	15,795	10,085	63.85
India	20,189	7,561	37.45
Indonesia	39,123	20,538	52.50
Israel	8,162	3,562	43.64
Malaysia	21,105	7,494	35.51
Philippines	17,325	6,730	38.85
Singapore	104,587	69,598	66.55
South Africa	18,744	11,321	60.40
South Korea	57,354	31,559	55.02
Thailand	24,802	10,075	40.62
Bulgaria	1,319	386	29.26
Croatia	7,004	2,123	30.31
Czech Republic	12,171	6,703	55.07
Hungary	16,115	4,946	30.69
Poland	23,775	9,210	38.74
Russia	37,390	10,011	26.77
Slovak Republic	3,577	1,297	36.26
Turkey	43,641	27,397	62.78

Note: Cross-border claims have a maturity of one year or less. Data are as of the end of March 2001.
Source: BIS *Quarterly Review*, September 2001