COMMENTS ON SESSION 2

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Thank you very much. First, I would like to say that the presentations were extremely good. I think some issues were explained in the presentations in a more balanced way than in the papers. So some of the concerns that Martin Naranjo and I had from reading the papers were addressed in the presentation, and therefore I will skip some of these comments. I think we can find three common issues in the papers presented in the session. First, the liberalization of the financial system in Latin America resulted in less optimistic outcomes than we expected when we started this process two decades ago. Second, globalization has challenged regulators and supervisors in many ways. Third, financial crises have brought about a review of the domestic and international frameworks for regulating and supervising the financial system.

I think there is also a fourth point that was absent in the papers but that is very important when we think about the future of the financial system in Latin America. I am referring to the challenges this system will face in light of recent technological changes and evolving trends in the global financial system. These trends will reshape the financial system in the near future.

I will refer to these common points as I address the three papers.

Regarding the liberalization process, it is obvious that we moved too fast in opening financial markets and did not move fast enough in changing the institutional framework. In some cases, we did not move an inch regarding the institutional setup. Liberalized financial markets need a very strong judicial and property rights system. The absence of these strong institutions generated huge costs and large financial crises in some of our countries.

However, I also feel that the liberalization process took advantage of a unique opportunity that was the failure of closed financial systems in the late seventies. Policymakers in Latin America took advantage of this situation to move ahead extremely fast. We can think of alternative scenarios in which liberalization would have been implemented in a piece-meal way and those reforms might have been backtracked significantly. Although we know today that a lot of these reforms led to financial crises and could have been implemented better, several of the alternative scenarios might have ended in a reform process that never got off the ground. Thus, even though we can lay out a better sequencing of reforms on paper and in theory, it is debatable whether, once we account for political economy considerations, they would have resulted in a liberalized financial system like we have today given the current political backlash to liberalization.

After the crises suffered by some countries, regulators and supervisors have responded to the challenge of rebuilding the international financial architecture in three important ways. First, we have improved our coordination with foreign authorities. Second, we are converging to international regulatory standards. And finally, we are reviewing prudential regulations and the international financial architecture. I think José María Fanelli's paper makes a good point regarding the bias in favor of developed nations that exists in negotiations in international forums. However, I think that the caveat here is that this bias has been changing. A good example is the discussion over the BIS accords. In the first Basle Accord, emerging markets were not taken into account in the deliberations. However, in the discussions of the second accord during last year, emerging and developing countries have had a very important input. In this regard, we have made some advances although we are not yet at the point where we would like to be.

Miguel Kiguel made a very interesting presentation regarding the liberalization and regulation of the financial system in Argentina. The financial system, after a long series of changes, no longer represents a source of vulnerability for the economy. Obviously, no financial system can resist five years of stagnation and the series of measures that led to its insolvency and illiquidity. So eventually the financial system became a victim of the crisis but not one of its main causes. However, Fanelli also made an interesting observation in his presentation that the cost of strengthening the banking system was to increase the borrowing costs for the corporate sector, and this, of course, has increased the burden for the private sector. We must realize that the risks are in the corporate sector and in Argentina's lack of access to international capital markets. In this sense, the only thing that banks were doing was trying not to become a shock absorber between the private sector and international financial markets. Therefore, corporations fully absorb the cost of the currency risk. A corporation in Argentina might produce goods for the domestic market but cannot get financing in domestic currency, so it has to go to the foreign market and borrow in foreign currency. Therefore, the only thing the banking system was doing was not getting in the way of that transaction.

In addition, it would be very interesting to see how costly the financial system in Argentina really is given its very high liquidity requirements and the need to build a private lender of last resort. The paper by Miguel Kiguel does not explore this question. The private lender of last resort is extremely costly, and these costs are being transferred to the private sector. It would be interesting to see what the implications are for the real sector of the economy in terms of corporations' cost of carrying out their banking business in Argentina compared to other countries that have a lender of last resort and a floating exchange rate.

In my opinion, some aspects of the comparison between the banking system in Argentina and Mexico made by Miguel Kiguel in his paper are unfair. In Mexico, we have just come out of a restructuring process in which the balance sheets of the banks were cleaned out. So, in a sense, we have much better balance sheets because the government restructured the banking system and not because the banking system exhibited good performance. Therefore, the banking system in Argentina today looks even better than what we see from these comparisons.

In his presentation (but not in the paper), Rogério Studart evaluated the reform of the supervision and regulation side of the banking system in Latin America based on the evolution of credit over the past two years. Obviously, credit allocation has been stagnant or extremely low compared to the levels we saw in the midnineties in some of the countries. But I do not think this is a good parameter to judge the success of these reforms because the system we had before promoted excessive lending. We did not have good regulation or supervision, and this generated a lot of reckless lending to the private sector. It is somewhat ironic that part of the success of the reforms implemented in the banking sector is that the banks are much more conservative and much more stringent in their evaluation of credit prospects. I think this is a very positive aspect, especially given that some of the institutional backing needed for the banking system to work correctly has not been changed yet. Thus, even though the changes in the credit part of the banking industry are not optimal, the result can be considered good given the lack of a solid institutional setup in our economies.

I would also like to present some thoughts on the reform of the domestic and international financial architectures. Emerging markets have been locked into a very bad situation for the past two or three years because we had a domestic financial architecture in place that was largely based on the international financial architecture. Some people think that such architecture was bad because it promoted crises through moral hazard. Personally, I am not convinced by this argument because there is no available evidence showing that capital flows to emerging markets were significantly affected by moral hazard. Regardless, we still do not have a viable alternative architecture after the post-crisis discussions of Asia, Russia, Brazil, etc. Currently, we have a sense of what the developed world does not want the international financial architecture to be, but a new, workable financial architecture to replace the old has not yet been constructed. So countries that built up financial problems under the old international financial architecture, such as Argentina and Turkey, are now trying to solve those problems under a financial architecture that is still under construction.

The struggle for recovery in these countries is greater in part because international financial institutions do not know exactly how these crises should be handled under the new financial architecture. Many of the proposals that have been presented make a lot of sense, but some of them entail trying to handle or anticipate problems or design financial instruments that incorporate the possibility of these problems developing. The financial instruments that we have today do not incorporate these elements. In this regard, we would like to see bonds with renegotiation clauses, automatic options for countries with financial problems to revert to, options to extend the maturity date, and clauses that allow for changing the characteristic of the bond. All of these options would be negotiated at the time the bond is issued. We would also like to see more contingent credit lines from official institutions such as the International Monetary Fund and from the private sector. But all these elements are not yet in place, so the private sector involvement being done on a case by case basis is extremely risky, extremely hard to anticipate, and generates problems for countries that are going through balance-of-payments crises today.

Hopefully, we will move forward with a design of an international financial architecture that will let us decide what the domestic financial architecture should look like, and doing so would allow emerging markets to reduce the high costs of crisis preventions being incurred today. These high costs are largely caused by the high liquidity requirements in Latin America. These requirements exist because of countries' need to develop domestic substitutes for the international financial architecture. For example, in Mexico, we have a floating exchange rate regime, but we have approximately U.S.$40 million in international reserves. This level of reserves is needed as a liquidity policy that partially substitutes for a more efficient international financial architecture. The same is true in both Brazil and Argentina, where the domestic financial systems have built up a huge liquidity cushion that is useful today but might not be needed under a better international financial architecture. In this sense, we are building extremely costly liquidity provisions that can eventually be replaced by a more efficient international financial architecture. The new system will replace these domestic liquidity mechanisms by pooling the risks of all emerging countries and not leave each country to try to build all these lifesavers on their own.

Finally, I want to conclude by noting the huge potential for growth that is present in the banking system in most Latin American countries. One only has to look at the numbers for the domestic financial systems of most Latin American economies and compare them with Chile, a country that is way ahead in its financial development. The huge underdevelopment in most of these systems creates a great potential for growth. For example, the ratio of bank accounts per inhabitant in Mexico, Argentina, and so on compared with the same number for Chile is in the order of 1 to 3 or 1 to 4. The amount of credit to the private sector in Mexico, Argentina, or Brazil compared with Chile is also relatively small. This means there is a large growth potential for our financial systems over the next twenty years if we do the right things. However, at the same time, we will also face many challenges, such as changes in information technology and the lack of formal credit history for our economic agents. But, eventually, we can visualize that it will be much easier for the private sector to access domestic capital markets. We lack this type of access today. So, in the future, our domestic financial institutions will face a very promising environment for credit demand but they will also be confronted with a much more competitive environment in the global financial industry.

Thank you very much.