Strengthening the financial system in less developed countries: the Latin American experience

Roberto Zahler

Financial system fragility in many developing countries is greater than in the industrial world. This fragility can affect the overall performance of the economy. It introduces microeconomic inefficiencies in the intermediation of savings into investment, and consequently limits economic growth. It may affect the proper functioning of the payments system, thereby increasing transaction costs and reducing overall productivity of capital, and it may be an important factor generating or, more likely, deepening a macroeconomic crisis. On the other hand, inappropriate macroeconomic policies can weaken significantly the functioning and the efficiency of the financial system, contributing to its fragility, which in turn may affect macroeconomic equilibrium, creating uncertainty, lowering output and reducing welfare.

The first section highlights the main lessons of the impact of macroeconomic policy on the strength of the financial system, particularly on the banking systems in Latin America. The second section refers to some of the major concerns and challenges for bank regulation and supervision in countries of the region.

Macroeconomic issues

Latin American countries' economic structure, their output and export diversification (by-products and by-markets) and their dependency on foreign saving imply that they tend to be *more prone to macroeconomic fluctuations and volatility*. These originate, on the one hand, from terms-of-trade shocks. Also, from changes to international interest rates, especially in highly indebted countries. Third, from international liquidity constraints and/or "excessive" capital inflows, based on how the major creditors assess a country's creditworthiness. Fourth, from "stop and go" domestic macroeconomic policies, which tend to exacerbate the booms and busts in economic cycles. And, finally, from high variability of key macroeconomic prices, such as the exchange rate, domestic interest rates and asset prices.

Regarding these issues, experience in Latin America suggests the need for policy to focus on:

1. Minimising the probability that domestic spending growth will deviate significantly, and over a long period of time, from a reasonable measure of potential output growth, i.e. by recognising the importance of achieving internal equilibrium.

The main reason for this is, on the one hand, that inflation in general, *but high and erratic inflation in particular* (unless there is widespread financial indexation), *is inimical to financial development*. This occurs since the real return on deposits becomes highly volatile, reducing the degree of monetisation and of financial deepening in the economy.

On the other hand, *macroeconomic instability correlates positively with higher vulnerability of bank debtors and with inappropriate and erroneous risk evaluation by the financial sector and, consequently, with banking system fragility*. Furthermore, the impact of an excessively expansive and/or contractive phase of a cycle (especially if it is not anticipated) is not symmetric regarding the vulnerability of the financial sector. What occurs in practice is that banks tend to get stuck with bad loans in the downward part of the cycle, while the credit standards of individual banks decline in the presence of "excessive credit growth", which tends to occur during the expansive phase of the cycle.

Macroeconomic policy should focus on the achievement of internal equilibrium in a stable, sustainable and credible way, by using pre-emptive action and adequate coordination of fiscal, monetary, exchange rate and wage policies.

2. Special care should be taken when considering the *adequacy of demand management policies*. Although official fiscal accounts may present a balance or even a small surplus, fiscal policy – in a relevant sense – may in fact be expansive and accommodate rapid and unsustainable total (including private) domestic spending.

Some countries present significant *central bank cash losses*, which tend to have their origin in exchange rate and foreign exchange sterilisation

policies but also in the bailout of domestic financial entities. These losses, or quasi-fiscal deficits, are equivalent to other types of public spending, having a detrimental effect on national savings, and should be taken into account when designing and implementing fiscal policy.

On the other hand, it could be argued that in many instances of financial reform in Latin America, the private sector has relied on *contingent fiscal transfers* in its evaluation of its income and wealth budgetary constraints. These "contingent" transfers, although excluded from the usual and accounting definition of fiscal spending, as well as from parliamentary discussion and approval, de facto, increase the private sector's expected wealth and affect its spending decisions. The region's foreign (and domestic) debt crisis of the early 1980s is a good example of the above. A more recent example is Mexico's "tequila crisis" of December 1994.

These contingent fiscal transfers should include an appropriate percentage of implicit, and certainly explicit, deposit insurance schemes, as well as of exchange insurance and other contingent support typically given by governments to banking system depositors, creditors and/or borrowers when facing a banking sector crisis. If these contingent transfers were taken into account, public sector liabilities would grow at a much faster rate than official statistics show. Such a situation would have beneficial effects on the economic authorities' evaluation of the soundness and sustainability of macroeconomic policy and the consequent need for the adoption of proper and timely corrective measures.

3. Together with overall appropriate aggregate demand policies, caution and wise judgement are required, especially, although not exclusively, in the *transition period* in economies undergoing significant reforms, i.e. from "repressed" to "liberalised" economies. *Speed, timing, intensity and sequencing* of price liberalisation, tax, trade, financial and social security reforms, as well as the opening of the capital account of the balance of payments, may make a huge difference to the evolution of key macro prices.

In fact, particular care should be taken when prices such as interest rates, exchange rates and asset prices tend to behave as *outliers*, in the sense of being divorced from their fundamentals or trend long-term equilibrium value over a prolonged period of time. This is due, on the one hand, to its macroeconomic implications. But also because debtors' capacity to service their debt is jeopardised and many reforms end up in a banking sector crisis. There is even a high probability of a less open and more repressed financial sector than when the liberalisation reform process started.

An important lesson that can be drawn from recent Latin American experiences is that aggregate demand policy should be directed at obtaining *stable and sustainable overall macroeconomic conditions*. Among these, the value and stability of key relative macro prices is a necessary condition. Wide fluctuations of relative prices transform dynamic and profitable sectors into problem sectors in short periods of time, and vice versa. Since banks share the losses but not the windfalls of their clients, defaults increase on average with the presence of unsustainable values of key macro prices in the economy.

4. Macroeconomic policy, and especially *monetary policy, may be extremely ineffective when some of these key prices are out of the norm*. In particular, although real interest rates should be positive, special care should be taken when they reach absurdly high levels over a significant period of time. There are a number of cases where no action was taken by the authorities, usually because it was argued that the interest rates, high as they may have been, were "market-determined". However, *since such interest rates might be much higher than any reasonable rate of return in the non-financial sectors of the economy, and because these sectors are the main debtors of the banks, such a situation may easily develop into a financial sector crisis*.

In addition, *monetary policy which is designed to be contractionary is not, in fact*. This is because such high rates of interest tend to be ineffective in moderating excessive spending. In fact, such rates are not binding on bank debtors' behaviour, given that borrowers expect to defer indefinitely the effective payment of those interest rates (rollover of loans) and/or to have their debt bailed out in one form or another. Under such conditions, extremely high interest rates do not contribute to rationing credit effectively and banks do not play their proper role in the transmission of monetary policy. What happens is that budget constraint is not operative and therefore excessive spending takes place, in spite of (and even because of) the presence of extremely high real interest rates, thus causing a simultaneous deterioration in both macroeconomic conditions and the quality of banks' loan portfolios.

5. An *adequate degree of flexibility* in macroeconomic policies has been shown to be an essential ingredient in the design and implementation of the more successful macroeconomic policies in Latin America. Under such circumstances, countries have been able to face the effects of foreign and/or domestic (supply-side) shocks in a timely and efficient manner. Furthermore, experience shows that *flexibility allows the effects of (positive and negative) shocks to be distributed throughout various markets*, which, in turn, contributes to a more balanced adjustment of the economy to these shocks. In the process, key macro prices do not tend to deviate significantly, or for a long period of time, from their fundamentals.

6. Latin American experience also suggests that policy-makers should be aware that *the current account of the balance of payments does matter*, i.e. that they are aware of the importance of achieving external equilibrium.

This understanding is especially relevant if a country has large gross foreign financing requirements due to a high stock of short-term foreign debt. Such an understanding is also important if it faces significant short-term "voluntary" capital inflows, since in that case the authorities may be "tempted" to rationalise the existence and persistence of large current account deficits on the grounds that such deficits do not originate from excessive domestic spending.

Emerging markets' high level of domestic interest rates, especially if foreign creditors do not have an adequate evaluation of country risk and/or exchange rate risk, tend to attract massive inflows of external capital, much of which is usually intermediated by the domestic banking system. Under such conditions *excessive domestic spending is not eliminated*, putting pressure on the (temporary) appreciation of the domestic currency and increasing the size of the current account deficit, while at the same time *domestic bankers tend to relax their credit standards, thus deteriorating the quality of their loan portfolio*.

Therefore, when facing such conditions, if monetary, exchange rate and sterilisation policies are well implemented, and if fiscal policy has made its contribution by generating a surplus, by limiting the rate of growth of spending and by having some degree of anticyclical effect, countries should consider a gradual and selective approach to financial opening-up. This can be achieved by reducing the speed at which domestic agents can get indebted abroad and/or by increasing the cost of short-term foreign financing. In this way the economy can slow the pace of overall foreign indebtedness, while at the same time reducing its vulnerability to foreign financial shocks. The latter is brought about *by changing the composition of the capital account of the balance of payments*, with incentives being given to risk capital (foreign direct investment) as compared to foreign debt, and to long-term foreign financing as compared to short-term external debt.

Furthermore, *scope appears to exist for increasing the risk awareness of foreign creditors regarding the domestic economies of developing countries. Responsibility in this area lies with creditor countries and with international financial institutions*. The improvement and homogenisation of information standards, better data on countries' aggregate exposure, and more in-depth analysis of country risk and exchange rate risk – by rating agencies and international financial institutions – may contribute to a more adequate and realistic approach to the supply of private international finance to developing economies.

7. A more structural aspect relates to the role of high domestic saving in developing economies: it allows for sustainable financing of investment, strengthens the domestic financial sector and makes the economy less vulnerable to foreign shocks. Recent experience suggests that high and sustained economic growth, a stable macroeconomic environment, deep, competitive and well-regulated domestic financial markets, pension fund schemes based on individual capitalisation accounts, tax structures that encourage (corporate) saving and penalise consumption spending, and high public (including central bank) saving explain the most successful cases of high saving rates in some Latin American countries.

Public saving plays a major role, especially in the process of financial liberalisation, where typically private saving tends to fall. And, although private pension fund systems tend to deepen domestic capital markets, they also tend to generate a fiscal deficit and may imply some banking disintermediation.

Financial reforms, regulation and supervision

1. A typical problem faced by many economies that engage in financial reform is that *traditional bank management is not aware of the implications of reform for its behaviour*, i.e. that in a liberalised and competitive

scenario, there is a crucial need for banks to engage in serious, responsible and *professional risk evaluation*. At the same time, especially during the bank privatisation process, many newcomers to the banking industry do not comply with the appropriate requirements for being bankers. A major challenge in Latin America is to ensure bank owners and managers have the skills, prudence and ethics required for sound and safe banking. If this is not the case, problems will tend to worsen, given the usually weak supervisory and regulatory capacity of the authorities, while at the same time the general public behaves as if there were an explicit and/or implicit public deposit insurance scheme.

2. The experience of Latin America suggests that *domestic financial liberalisation as well as the opening of the capital account of the balance of payments should proceed in a gradual and, if possible, in a selective way*. If reforms are poorly designed in terms of pacing or sequencing, they may generate huge distortions during the transition from a repressed to a liberalised situation. The right speed at which to liberalise the domestic financial sector relative to the foreign financial sector or the right sequence in which to open trade and to liberalise the financial sector are not the same in every country under different initial conditions. Additionally, the sequencing of financial reform should be a function of how profound the adjustment and stabilisation policies have been, i.e. the degree of macroeconomic equilibrium that has been achieved, as well as of the effective capacity of the supervisory and regulatory authorities of the financial system.

3. Opening-up and domestic financial liberalisation stimulate credit growth and foreign indebtedness, increasing a country's vulnerability, due to a higher dependency on external savings. If these reforms coincide with the expansive phase of a cycle, problems related to excessive credit growth, quality of bank loans and overindebtedness tend to amplify.

These problems are exacerbated when financial reforms go hand in hand with very high domestic real interest rates and appreciated domestic currencies. In this case, which is quite common, perverse incentive predominates in the working of the financial system. On the one hand, the loan portfolio tends to concentrate in the non-tradable sector and adverse selection tends to be the norm. On the other, rollover of the non-performing loans of overindebted agents increases, so as not to recognise losses. Furthermore, a bubble of (mainly non-tradable) asset prices is generated, which not only simulates further credit growth and spending, the latter due to a wealth effect, but also distorts the appropriate valuation of collateral in the bank lending process, thus increasing financial fragility.

In addition, given the need for liquidity, banks' competition for deposits tends to increase interest rates even further. That process increases the risk of their portfolio, with little or no risk return considerations being made by depositors when, as is usually the case, explicit or implicit deposit insurance and/or guarantees exist. This risky behaviour tends to be aggravated when there is a low level of bank capitalisation, generating the well-known "agency problem", where the bank no longer defends the interests of its depositors, becoming an agent of some borrowers (usually related to the bank shareholders).

4. Special consideration should be given *to the way in which regulators consider the match between banks' assets and liabilities*. For example, a common mistake is not to analyse the characteristics of the economic agents indebted to the banking system in foreign currency, i.e. regulators may feel comfortable with the fact that there tends to be a reasonable balance between banks' assets and liabilities denominated in foreign currency, but they may be missing a crucial point: the exposure of banks' debtors to a change in the exchange rate.

In other words, if bank loans in foreign currency are concentrated, for example, in debtors of the non-tradable sector, and a big exchange rate change takes place, the value of those loans should be downgraded. The reason is that the debt service capacity of those debtors is reduced when the domestic currency depreciates. So even though banks' assets are matched with banks' liabilities in terms of foreign currency, debtors may be unable to absorb exchange rate fluctuations. In summary, an exchange rate change may increase the debt burden and the risk of financial instability, in spite of the fact that there may be a match between bank assets and liabilities in foreign currency. Thus regulators must be extremely cautious, exercising judgement in evaluating risk and not limiting themselves to one kind of accounting analysis.

5. The Latin American experience with capital market deregulation, and particularly with financial liberalisation, shows that *establishing adequate*

regulatory and supervisory frameworks remains at the top of the agenda. Some of the issues on which the region's banking regulation and supervision should concentrate are:

a) Institutional development of banking supervision itself: political support, i.e. a high degree of political independence, adequate staff, resources and training programmes.
b) Preventive and prudential approach aimed at anticipating problems, evaluating them and taking appropriate corrective measures, before they appear.
c) Adequate incentives so that market signals will increasingly contribute to monitoring banks.
d) Transparency in the functioning of the financial system, through appropriate financial accounting and disclosure.
e) Strengthening the working and scope of private agents, such as external auditors and rating agencies, while at the same time making them more accountable to bank supervisors.
f) On site inspections and bank management consultations.
g) Adapting, in a more strict and demanding way, agreed minimum capital standards (such as those of the Basel Committee on Banking Supervision), to compensate for higher macroeconomic vulnerability, higher risks and poorer supervision in many Latin American countries. Furthermore, individual asset risk criteria should be complemented with exchange, interest rate and loan diversification risks, when defining the appropriate capital requirements for banks in these countries.
h) Balancing carefully the benefits of internationalisation of domestic banking, which tends to diversify portfolio risk, with proper and adequate regulation and supervision. Although it is true that the risks of banking are greater in small economies than in economies where there are more opportunities to diversify, many small and not-so-small economies lack the capacity required to oversee bank lending or investment abroad. And those markets may have a higher country risk, contagion risk and arbitrage risk, in addition to a different sort of regulation and supervision.

   The fact that obtaining information is usually more costly in other countries, the differences in national accounting practices and the possible inconsistencies among countries' banking laws, supervision and regulations, suggest that the increase in the scope of international banking activities should proceed in a gradual and prudential way. Information sharing and coordination among national supervisory agencies should be a necessary condition in the initial stage of domestic banking internationalisation. If this is not the case, banking activities outside the home country may end up increasing rather than reducing banks' overall portfolio risk.

i) The need for consolidated supervision is another major challenge for countries where conglomerates exist or are being created "de facto", and where banking and financial operations are just one of their economic activities. This is particularly relevant when these conglomerates look for opportunities abroad, in terms of acquiring real and financial assets and/or, in the case of banks, lending abroad.

j) Avoidance of contagion effects and intermediation of low-risk emerging market countries as a vehicle to increased exposure by third parties in higher-risk less developed countries. This situation may offer attractive arbitrage opportunities, but at the eventual cost of triggering in the first countries explicit or implicit government or central bank guarantees, and should therefore be avoided.

k) Countries where financial reforms and banking legislation are relatively advanced and where non-bank financial intermediaries, typically pension funds, have acquired an important dynamism and play a key role in the capital market, face an important challenge: to achieve consistency regarding the norms, regulation and supervision that relate to different financial intermediaries. In other words, the process of disintermediation requires a gradual adaptation of financial legislation and supervision. This adaptation should be oriented towards strengthening the institutional set-up of regulatory and supervisory agencies, as well as their "intercoordination". This is necessary so as to incorporate changes as they appear and deepen the modernisation and efficiency of the overall financial system (not only banks) and its contribution to the ongoing process of saving and investment.

l) Another major challenge for regulatory and supervisory agencies in emerging countries relates to the risk involved in the rapid development of new financial techniques and instruments.