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# The Financial System

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Periodic financial crises have characterized the economic history of Latin American countries. Relatively low rates of saving and their corollary, a high dependence on foreign capital inflows, create the conditions for financial crises. An external or internal event, such as an impending debt default or a bank failure, creates a lack of confidence, which in turn puts pressure on bank deposits—especially those in local currency—and on the foreign exchange markets, so that domestic credit gets squeezed. The room for central bank action is limited, because any countercyclical moves are interpreted as putting more pressure on international reserves. As a result, financial crises tend to be prolonged, with costly negative effects on economic growth.

The period of economic reform since the late 1980s should have been followed by a lessening of the frequency and duration of financial and banking crisis, but this has not been the case. In the 1990s alone, there was a major banking crisis in Venezuela in 1994; the so-called tequila devaluation-cum-banking crisis in Mexico in 1995, when GDP fell about 6 percent; and the large devaluation followed by some bank failures in Brazil in 1999. In addition, there were serious strains in the banking systems of Colombia, Ecuador, Peru, and even to some degree of Chile; in these countries, the late 1990s was a period of credit disintermediation and drought for most companies other than the largest. Hardly any country escaped some kind of serious financial and banking problem in the course of the decade. To be sure, most of these problems were the result



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of, or were closely intertwined with, macroeconomic disturbances—particularly devaluation. But that was not always the case (e.g., Peru 1999-2000 and Venezuela 1994).

The notable fact is that these financial crises and problems took place at a time when most Latin American economies enjoyed foreign capital inflows as never before, at least since the 1920s. For the 1990s, foreign capital inflows averaged almost 4.5 percent of GDP annually, fairly steadily throughout the period. So what has been the cause of financial instability?

## Low Domestic Savings Rates and Their Consequences

A central theme in any analysis of capital markets in Latin America is that of domestic savings. The main difficulty in discussing the performance of savings is whether savings rates are simply an outcome of other variables, particularly of the growth of income, or whether savings as such affect income and capital formation. The literature on the subject is not conclusive.[1] Various correlations over relatively short periods are not fully convincing because domestic savings rates move slowly over long periods. Despite these conceptual difficulties, the fact remains that in emerging-market economies higher savings rates have been associated with higher rates of economic growth and vice versa, at least over long periods. Attempts to push up domestic savings may be futile—and may in fact slow growth—but it seems clear that dynamic economic growth does not survive for long unless it is accompanied by a strong performance of savings.

The fact is that gross domestic savings in Latin America are in general quite low. For a reasonably representative sample of countries, gross domestic savings averaged about 20 percent of the GDP during the 1990s (see table 1.3 above), with a slightly declining trend as a result of the recession at the end of the decade. Particularly notable was the fall in the savings rate in Chile, the high-end saver of the region, from about 28 percent of GDP in 1990 to 22 percent in 2000, in large part reflecting the decline in the price of copper.

Savings rates are notoriously hard to measure and are usually calculated as a residual item so that estimates can be inaccurate. Despite the difficulties of calculation, because most Latin American countries are relatively low savers, they are especially dependent on foreign capital inflows to finance their capital formation. These reached an extraordinarily high level during the 1990s; the fact that the bulk of these inflows came from foreign direct investment, a somewhat more stable source than portfolio investment, does not necessarily make them more buoyant in the long run. The turmoil and decline in financial markets in 2001-02 casts

1. E.g., see the review by Gavin, Hausmann, and Talvi (1997).



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serious doubt on the sustainability of foreign investment inflows in the immediate years ahead. The obvious result is that Latin American economies may find it difficult to recover and then sustain higher levels of economic growth until the inflows of foreign savings and especially the level of domestic savings starts to recover.

The crisis in Argentina, which blew up in December 2001 with the collapse of the government and the default on the public debt, has further dampened the prospects for foreign direct investment in the region. This deterioration is the result of poor growth in the region, of the financial problems in major countries such as Brazil and Argentina, and especially of the huge write-offs foreign investors have had to make in Argentina. These in turn were the result of the asymmetrical treatment of peso and dollar assets and liabilities (probably $10 billion or more in write-offs for banks) and of tariff freezes on utilities (another similar amount in write-offs for companies in generation, transmission, and distribution of gas and electricity, and also telephones). These losses were so large that they affected the ability of the companies involved to make new investments, not just in Latin America but in some cases also elsewhere. It is a new type of "contagion."

The collapse in private-sector finances in Argentina was preceded by a gradual but persistent deterioration in public finances. Even though the public-sector deficits were not all that large (in the range of 3.5 percent of GDP during the period 1996-2001), the fact that there were few domestic sources of savings to finance the deficit forced the government to go abroad increasingly to borrow at ever higher rates of interest. The ensuing crisis of confidence eventually became untenable in 2001, because the premium Argentina had to pay (over the US Treasury benchmark rate) rose as high as 20 percent and even 50 percent in the final days of crisis. In the end, the Argentine crisis was therefore as much a crisis of inadequate domestic savings as of the public deficit itself, which was exacerbated by the perennial deficits of regional governments.

A key component associated with growth is thus not just overall savings but in particular public-sector savings. It is true that over short periods a rise in public savings induces the private sector to save less (Gavin, Hausmann, and Talvi 1997, 8), but it also seems intuitively true over long periods that if the public sector is a dissaver, it is sending a message that dissaving is acceptable. That message, in financial terms, gets translated into an overly large presence of government borrowing in the domestic capital market, a problem for some of the larger Latin American economies in recent years, Argentina and Brazil in particular. The domestic public debt is relatively high in Brazil; for example, it reached 60 percent of GDP at the end of October 2000. The result—even recognizing that there are other causes of the large pressure of governments in the capital market—is a tilt of the domestic capital market toward government debt, which is tax exempt in most countries. Even though the private sector



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generates the bulk of domestic savings, in domestic financial markets it is governments that dominate on the borrowing side.

In order to remove obstacles to the formation of domestic savings, it is probably essential, as a first step, to build a solid foundation for public-sector savings—which rely heavily on social security systems in a number of countries—and at the same time to improve the outlets for existing domestic savings. This last point means streamlining and making more efficient banking systems and capital markets, to improve the returns on savings and thus provide an incentive for their buildup.

The performance of Latin American banking systems and capital markets in the past decade has by and large been poor. After a period of high growth in 1989-94, local equity markets went into hibernation in the wake of the tequila crisis; from compounded annualized rates of return of about 25 percent in 1989-94, returns fell to next to nothing in 1995-2000, a period of boom in US and European stock markets.[2] Returns on bank capital more or less followed the same trend, as banking crises followed after Mexico in Brazil and Argentina, and also in Chile, Colombia, Peru, and Ecuador, as well as Venezuela earlier. Domestic debt capital markets were somewhat less erratic but still suffered serious difficulties. Overall, the financial returns on savings have been low, a factor that obviously discourages the transformation of savings into financial assets.

## Pension Systems

Pension systems are a major potential source of savings. At the same time, if they are not properly managed, they can become a big source of dissavings when the systems are underfunded and then have to rely on large budgetary transfers. This has already happened inter alia in Argentina, Brazil, and Colombia. In Colombia, for example, the present value of future government pension liabilities is 200 percent of present GDP and social security pension payments are more than 20 percent of the public-sector budget. For most countries, pension reform is an urgent priority, not only for obvious budgetary reasons but also to avoid major pressure toward dissavings in the future.

In addition, there are demographic reasons for pension reform. Because of dramatic progress in health and longevity along with a dramatic drop in birthrates, the aging of populations, especially in South America, is no longer an academic question but rather a reality that is beginning to spread northward from the countries of the Southern Cone (Argentina, Chile, and Uruguay) (see the discussion of demographic data below).

Fortunately, one of the most positive trends of recent years, in the sense of creating channels for financial savings and thus for credit, has been the

2. Data obtained from the International Finance Corporation.



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strengthening of pension systems in many countries of the region. This evolution has taken three forms. The first has been the replacement—partial or complete—of government pension systems by private ones administered using efficient financial criteria. The second has been the reform and simplification of several of the surviving state social security and pension systems. The third has been the insertion of both private and public systems into the financial markets of their respective countries and also into international investment markets.

The Chilean pension reform of 1981 was the pioneer in the field and is therefore the most imitated, at least in part. The genesis of the pension reform was a report by a private group of economists in 1972, in the middle of the Salvador Allende administration, that analyzed the serious flaws of the public system. As of the mid-1970s, that system consumed 21 percent of government outlays, with a bewildering variety of benefits and systems. These were replaced by a privately administered system with a number of approved pension fund administrators. The transition from the government system to the private one was initially quite costly in fiscal terms because older workers stayed with the public system while younger ones moved en masse to the private system and took their accumulating contributions with them. In the initial transition years, the social security deficit rose from about 1.5 percent of GDP in the late 1970s to 7.5 percent in the early 1980s, after the new system was in place.

Despite the initial fiscal cost of the switch, there is little doubt that over time the new system contributed substantially to strengthening domestic savings. To arrive at a judgment on the effect of the new system on national savings, one needs to distinguish between the enormous swings in the business cycle in the early 1980s—30 percent unemployment in 1982 would have created a social security deficit anyway—and the long-term trend of savings in the economy in the 1980s and 1990s. By the early 1990s, after several years of growth from the mid-1980s onward, Chile's gross domestic savings rate was the highest in Latin America—27 percent of GDP. This level was close to that of the most successful Asian economies of the time.

That high level of saving in Chile cannot be attributed solely to pension reform, but rather to the whole panoply of measures and liberalizing reforms that made possible rapid growth. The accumulated assets in the private pension system—about $41 billion in 2001, or the equivalent of 60 percent of GDP—did make one very major contribution to the growth and efficiency of the economy in Chile, namely, the creation of a lively and liquid domestic market for long-term corporate bonds and also for corporate equity.

This achievement enabled Chilean companies, especially the larger and more solid ones, to finance themselves in the domestic market at long-term and reasonable cost, in sharp contrast to comparable companies in other Latin American countries, where there has been little in the way



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of a domestic bond market or long-term domestic financing. By the early 1990s, private pension funds owned about 60 percent of the corporate bonds outstanding. More than anything else, the attempt to create a stable source of domestic long-term finance has been one of the two main motivations for other Latin American countries—especially Argentina, Colombia, Mexico, and Peru—to copy Chilean social security reform. The other motivation has been, of course, to eliminate a big drain on the budget.

The basic features of the new Chilean pension system are simple. All those with a salaried job must make a tax-free contribution of 10 percent of their salary (for the first $1,500 per month[3]) to a pension fund; they have the right to select an approved pension fund manager (*administradora de fondos de pensión*, or AFP), and they have the right to switch the AFP as often as they like (but not before 4 months with the new AFP). A special government agency regulates the investments that AFPs can make and the fees they can charge, within a range; upon reaching the mandatory retirement age of 65 years for men or 60 for women, the pensioner can choose to convert his or her AFP assets into a life policy purchased from an insurance company (the choice for most) or take the risk that the pension will cut off at death (with half the benefits going to the surviving spouse). The system is not a defined-benefit one but rather a defined-contribution one, although the pension fund must meet a certain minimum pension; if it is unable to do so, the government provides a small guaranteed minimum pension, although in fact this guarantee has not been used.

The Chilean pension scheme has both benefits and disadvantages. The fiscal benefits are obvious, as is the major contribution it has made to the development of the capital market, despite the tight regulations governing investments. Only "AFPable" investments are allowed, rated by local credit agencies, and there are limits on each category of investments—such as domestic corporate bonds; rated domestic equities (company shares are rated in Chile); up to 15 percent in rated and liquid foreign securities; and so on. The major advantage for beneficiaries is the portability of pension benefits, a big plus for labor mobility in an economy where the majority of the labor force is employed in medium-sized and small businesses that are likely to change or fold within the lifetime of a worker. Tight supervision of the AFPs avoids abuses of the type that have sometimes occurred in other settings. In the United States, for instance, there have been over the years—despite the provisions of ERISA[4]—well-documented raids of corporate pension fund assets by less-than-reputable corporate managers.

Conversely, returns were poor or negative in the late 1990s. In real terms, the average return for the system was a cumulative total of 3.8 per-

3. Up to 60 *unidades de fomento* (UFs) can be saved monthly through an AFP, tax exempt. A UF is worth about $30 at present.

4. The Employee Retirement Income Security Act of 1974.



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cent for the 3 years ended June 1998, or just above 1 percent a year.[5] Before that time, the pension funds had failed to diversify sufficiently, and then in 1998 they pushed hard to increase their investments abroad rapidly, putting pressure on the Chilean peso.

The main criticism leveled at the pension system is its cost, which at about 1.5 percent of assets under management is broadly comparable in percentage terms to that of United States defined-benefit corporate pension plans, but at a significantly lower level of income and benefits.[6] To avoid a price war in financial services, the pension fund legislation limits price competition among AFPs; to attract clients, therefore, the AFPs employ an army of salespeople (18,000 in 1998). Turnover of clients is high—about once a year per client—and sales expenses represent about 15 percent of AFP costs (plus advertising), arguably a questionable use of resources. As long as the domestic bond and equity markets were buoyant, the issue of cost was not important. But the weak performance of the domestic market in the late 1990s pushed to the fore a discussion not only of costs but of portfolio diversification. If the weakness of the domestic capital market continues, the movement abroad of $4 billion to $6 billion of AFP assets could become a destabilizing force in the Chilean balance of payments, a point of concern to the central bank.

The Chilean private pension system has been one of the country's most successful exports, although as an intellectual export it has yielded few returns other than satisfaction for its creators. Today Argentina, Bolivia, Colombia, Costa Rica, El Salvador, Mexico, Peru, and Uruguay all have pension systems patterned in one way or another on Chile's, whereas Brazil has a number of large individual company pension funds, along the lines of the defined-benefit plans in the United States. These countries followed the system of independent specialized pension fund managers, the portability of pension contributions from one manager to another (a key feature of the Chilean system), and the regulation of permissible investments by a special authority. Most countries did not follow the Chilean example of a sunset for the state system, although a few—such as Peru—are gradually legislating a shift of most workers to the private system.

The results of the implementation of the Chilean system have been highly favorable in helping to develop the local bond market and in forcing state systems to straighten out their finances. The outlook for the pension fund management industry in Latin America appears to be buoyant for a decade or two while populations are still relatively young—although not for much longer—and provided participation rates in the formal labor force start to rise again as more females go to work in the formal sector. The obstacles are well known: delinquencies by workers in paying up their retained contributions, the desire of legislators to give more up-front

5. Superintendencia de Administradoras de Fondos de Pensiones (1998).

6. See Diamond and Valdés-Prieto (1994, 259-61).



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benefits to workers before the savings accumulate—as was attempted in Colombia in 2000—excessive regulation of investments (Mexican retirement funds, known as AFORES, are still not allowed to invest in equities).

The worst danger comes from governments trying to stuff their bonds into pension funds, as happened in Argentina in the late 1990s and in the period 2000-01, thereby effectively bankrupting the pension system once the government defaulted on its public debt at the end of 2001. The outlook for the pension system—both public and private—in Argentina is at best guarded because, even if the state resumes service on its debt in some form at some point, a probably irreparable breach of trust has occurred. Pensioners have longer memories than bank lenders, because they do not have lenders' write-offs.

Projections by observers of the field (the principal one of whom is José García-Cantera at Citibank/Salomon Smith Barney) show that the assets under management of the main Latin American private pension funds are expected to rise rapidly, from about 20 percent of GDP in 2001 to 38 percent in 2015 (table 5.1). The projections for Argentina are obviously highly uncertain. Even leaving out Argentina, the assets under management would reach about $700 billion, or 39 percent of the GDP of the countries involved.

The evolution and improvement of pension systems is perhaps the most important development in Latin American financial development since the scrapping of interest controls and differential reserve requirements in the 1980s. In a sense, it was high time these improvements took place. Because population growth rates are falling off sharply everywhere, especially in southern South America, there is a danger—if nothing is done—that Latin America could become the region of the world that grows old before it grows up. It is estimated that in 2050, 22 percent of the population of Latin America will be 60 years of age or higher, compared with 8 percent today. More telling, that percentage compares with 16 percent in North America today. Although today 11 working-age persons support 1 person 65 or older in Latin America, that ratio is expected to be 4 to 1 in 2050—a major deterioration. Pension fund reform is therefore a high priority if pension systems are to be viable.

To maximize the benefit for capital market development of growth in the next two or three decades, pension systems—today mostly private systems—must secure better integration of pension management, life insurance, and credit systems. The link between the first two is already developing, as potential pensioners take out life insurance annuities in lieu of pension benefits. But the third variable really needs to be developed; the pool of contributors to pension funds is potentially one of the most reliable groups of potential recipients of credit that exists. Yet banks, many of which are direct or indirect owners of pension management companies, have so far made only limited efforts to harness this pool of potential borrowers. Once they do so, there could be a revival of consumer and mortgage credit on a far more solid footing than existed in the 1990s.



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**Table 5.1 Projected assets of private pension funds, selected Latin American countries, 1999-2015**

| | Assets under management (billions of US dollars at current prices) | | | | Assets as a percent of GDP | | | |
|---|---|---|---|---|---|---|---|---|
| **Country** | **1999, actual** | **2001, estimate** | **2005, projected** | **2015, projected** | **1999** | **2001** | **2005** | **2015** |
| Argentina | 16.8 | 26.1 | 55.2 | 181.4 | 5.9 | 8.7 | 16.4 | 34.6 |
| Bolivia | 0.6 | 1.7 | 4.3 | 9.0 | 7.6 | 17.1 | 34.1 | 44.7 |
| Brazil | 68.3 | 87.0 | 118.4 | 282.0 | 13.2 | 13.9 | 16.0 | 24.5 |
| Chile | 34.5 | 40.8 | 59.5 | 126.8 | 51.4 | 56.2 | 68.7 | 98.9 |
| Colombia | 2.9 | 5.0 | 11.7 | 58.3 | 3.4 | 5.9 | 11.9 | 37.9 |
| Mexico | 18.4 | 38.6 | 67.0 | 196.5 | 3.8 | 6.4 | 9.8 | 21.4 |
| Peru | 2.4 | 3.7 | 7.8 | 27.5 | 4.7 | 6.9 | 12.3 | 29.4 |
| Uruguay | 0.6 | 1.0 | 1.8 | 5.1 | 2.9 | 4.4 | 7.2 | 13.4 |
| **Total/average** | **144.6** | **203.8** | **325.9** | **886.5** | **19.8** | **20.0** | **24.4** | **37.7** |

*Source:* Salomon Smith Barney, *Private Pension Funds in Latin America, 2000 Update.*



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## Banking Systems

If savings are a key—but only partially explained—symptom of macroeconomic health, then a sound and dynamic banking system is a crucial—if not the only key—ingredient of financial health. At one end, capital markets cannot exist without banks to finance their operations; at the other, medium-sized and small businesses, which provide the bulk of employment, cannot thrive unless they have access to credit at a reasonable cost and at a maturity which is realistic for them.

Unfortunately, on both these counts but especially on the second one, Latin American banking systems have failed dismally, with few exceptions. The basic reason for this failure has been the behavior of governments, which nationalized banking systems (Mexico in 1982) or put in regulations and controls that amount to nationalization (Argentina, 2001; Peru, 1987; Chile, 1982; and Ecuador, 2000). The result has been a culture of risk aversion, which banks try to protect through oligopolistic behavior. Competition among banks is limited, except for top corporate clients. For other clients, it is rare to see major competition, especially after the disasters in a number of countries in the 1990s in what were once seen as potential growth areas, such as consumer credit.

The building up of a competitive and dynamic banking system is a long-term task that requires a series of pedestrian steps such as better-informed banking supervision, credit information, changes in regulations (which discriminate in favor of holdings of government paper), and other steps reviewed below. This is not a glamorous agenda. In the meantime, the central problem of banking systems in Latin America other than Chile and Uruguay is low coverage; in Argentina, for example, even before the crisis only 10 percent of the adult population had a bank account.

On the asset side, commercial banks focus on the larger companies. The forays into consumer finance during the boom years of the mid-1990s ended with big losses in the late 1990s in countries as diverse as Argentina, Chile, and Peru. In Mexico, mortgages, credit cards, and consumer credit essentially shut down after 1995 for several years, for default rates reached more than 90 percent after the devaluation.

A key ingredient in widening the credit and deposit base is lower inflation. Most countries in Latin America have made significant progress here in recent years (table 5.2), but some inflationary expectations persist in the wake of the Argentine crisis. Lower inflation brings down nominal interest rates and thus tends to improve the creditworthiness of borrowers, especially because inflation tends to reduce the real incomes of poor people and of smaller enterprises that have no pricing power.

If lower inflation is combined with improved confidence in the political and economic outlook, the decline in interest rates can be dramatic. In Peru, for example, once the political outlook clarified for a time after the



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**Table 5.2 Inflation in selected Latin American countries, 1995-2002 (average annual percent change in consumer price index)**

| Country | Average for 1995-99 | 2000 | 2001 | 2002, estimate |
|---|---|---|---|---|
| Argentina | 0.8 | –0.9 | –1.1 | 40.0 |
| Brazil | 9.0 | 7.0 | 6.8 | 7.3 |
| Chile | 6.0 | 3.8 | 3.6 | 2.8 |
| Colombia | 17.9 | 9.2 | 8.0 | 6.5 |
| Mexico | 24.2 | 9.5 | 6.4 | 4.7 |
| Peru | 8.3 | 3.8 | 2.0 | 0.9 |
| Venezuela | 51.7 | 16.2 | 12.5 | 24.9 |

*Source:* Country statistics, as shown in JPMorgan, *World Financial Markets*, fourth quarter of 2002 and earlier issues.

June 2001 presidential elections, interest rates plummeted. The interbank domestic rates went from 13 percent (in dollars) and 15 percent (in soles) to 2.5 percent at the end of that year, almost equivalent both for soles and dollars. This precipitous decline, combined with a shift away from dollars into local currency, gradually led to an improvement in the volume and cost of bank lending at the beginning of 2002.

Public confidence in banking systems in most economies of Latin America remains low. There are many reasons for this mistrust, but episodes of high inflation and even of hyperinflation (e.g., Argentina and Peru in 1989-90) are one of the main reasons. As a result, any major sign of political or financial trouble leads to significant deposit withdrawals. These withdrawals in turn lead to credit squeezes (Braun and Hausmann 2002), which tend to be deeper and more prolonged in Latin American economies than in other emerging markets. According to Braun and Hausmann, "credit crunch" episodes in Latin American economies in the 1980s and 1990s lasted longer (2 years) than in other developing countries (1.5 years) and were more intense (Braun and Hausmann 2002, tables 2 and 3). Even allowing for the fact that the debt crisis of the 1980s affected Latin America far more than other regions, the sharpness and duration of credit squeezes in Latin America is notable.

During the past decade, as foreign banks—particularly Spanish banks—sharply increased their participation in local banking systems, it was thought that this trend would give banking systems greater stability. Foreign banks have about half or more of total system assets today in Argentina, Mexico, Peru, and Venezuela, and almost half in Chile. The strengthening of local banking systems was assumed because of the high quality of the acquiring foreign banks, particularly Santander Central Hispano and Bilbao Vizcaya Argentaria of Spain, Hong Kong Shanghai (renamed HSBC) of the United Kingdom, and Citibank. The Spanish banks, in particular, thought that they could expand deposit and credit coverage



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**Table 5.3 Degree of effective protection for creditors, selected Latin American and Caribbean countries and comparator groups** (scale: 0 to 1.0)

| Group or country | Degree of protection |
|---|---|
| **Latin America** | 0.14 |
| Trinidad and Tobago | 0.48 |
| Panama | 0.30 |
| Bolivia | 0.21 |
| Chile | 0.19 |
| El Salvador and Venezuela | 0.16 |
| Brazil | 0.11 |
| Ecuador | 0.08 |
| Peru, Mexico, and Colombia | Less than 0.05 |
| **East Asia** | 0.47 |
| **Industrial economies** | 0.38 |

*Sources:* Inter-American Development Bank; estimates given in Galindo and Micco (2001) and La Porta, López-de-Silanes, and Shleifer (2000).

rapidly. Unfortunately, the foreign banks have faced a timing problem. They expanded in the mid-1990s, only to be promptly thrown into the recessions of the late 1990s.

The reasons that expectations have failed to materialize are thus partly macroeconomic—as in Argentina, Colombia, Peru, and Venezuela. They also reflect lack of progress in the basic legal underpinnings of banking systems and their supervision.

Creditors in a number of Latin American countries—notably Colombia, Mexico, and Peru—have a low level of legal protection. Recovering the assets underlying a mortgage can take 2 years or more; in 2002, Peru passed legislation sharply restricting the activities of collection agents, a major setback for the expansion of consumer credit. The lawmakers also imposed exaggerated limitations on credit documentation, such as eliminating blanket guarantees. Various studies suggest that creditors have a low degree of protection in several major Latin American countries;[7] this is particularly true of Brazil, Colombia, Mexico, and Peru. The degree of protection in Latin America is on average far below that in East Asia and in industrial countries (table 5.3).

The practical manifestation of this is legislation that protects those who do not pay, and inadequate information from credit bureaus, so banks are naturally inclined to lend only in situations where there are strong guarantees and where the guarantees are easily accessible in case of default. Clearly, most Latin American countries have to change credit legislation to make it more flexible if credit is to expand, especially toward smaller

7. These various studies, sponsored by the Inter-American Development Bank, include Galindo and Micco (2001) and La Porta, López-de-Silanes, and Shleifer (2000).



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enterprise. Unfortunately, the legislative trend has been in the opposite direction in recent years.

Another important area is that of bank supervision. Although much progress has been made in strengthening bank supervisors, they are still slow and formalistic, and they are seldom assisted by the judiciary. For example, a bank that failed in Peru in December 2000 was still unsold in July 2001, when a new government came in and ordered its liquidation. The process of liquidation was interrupted by a judge on a technicality, which delayed the process and thereby accelerated the deterioration of the bank's loan portfolio, which hurt creditors and depositors alike.

At present, state-owned banks still account for almost 20 percent of banking system deposits and assets regionwide. The percentages are especially high in Argentina, Brazil, Costa Rica, and Uruguay. Recently, there have been divestitures of state banks, notably in Brazil, with the sale of Banespa (Banco do Estado de São Paulo) to Banco Santander Central Hispano in 2000. State-owned banks with commercial activities continue to be active inter alia in Argentina, Brazil, and Peru.

In Argentina, Banco de la Provincia de Buenos Aires is one of the largest retail banks, whereas Banco Nación is a large but inefficient farm lender whose functions extend well beyond its treasury and paymaster role for the government. Banco do Brasil, the largest bank in that country, performs well below its commercial peers. And in Peru in 2001, the functions of Banco de la Nación, basically a state treasury, were extended to granting retail loans to government employees.

Although these incursions of the state into commercial activities are usually justified by the lack of banking facilities in remote areas, the inefficiencies of these state banks and the diversion of state resources into activities that could be performed commercially by others suggest the need for a different approach, which would emphasize incentives for banks to spread to poorer and remote areas in exchange for government deposits, for example. As part of the process of reform, state-owned commercial banks should gradually disappear and have their commercial functions taken over either by commercial banks or by state treasuries.

The various difficulties faced by banks in Latin American economies—inflation, lack of standardized credit information, legal difficulties in collection, competition by state banks—mean that the risk premium for loans is high, anywhere from 5 to 15 percent above the cost of deposits, and that loan maturities are very short, usually no more than 1 year except in the limited cases where mortgage loans are possible (Chile, Colombia and, to an extent, Mexico and Peru). Maturities are usually quite unsuited to the purpose of the loan, such as capital investments in agriculture and industry that may take several years to mature.

The short maturities induce borrowers to borrow from Peter to pay Paul, causing debt costs to rise and greatly increasing the risks of default. These risks have led to the creation of specialized lending vehicles, such as leasing companies and industrial and agricultural banks, as well as



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specialized banks for small borrowers (on the model of the Grameen Bank of Bangladesh or Banco Sol in Bolivia). The record of these institutions has been mixed; for state-owned "development" banks, it has been weak, though leasing companies and specialized banks for small borrowers have a stronger track record.

In the end, the only solutions that can promote lower-cost and longer-term credit from financial institutions are those that tackle the causes of financial insecurity: inflation, poor credit information (which accompanies tax avoidance and poor tax records), and excessive protection of borrowers' rights. In addition, greater competition in the provision of credit is also a necessary ingredient—and that is best provided through the development of active and transparent securities markets, especially domestic bond markets.

## Domestic Bond and Securities Markets

With declining inflation, except in Argentina and Venezuela, the prospects for developing local bond markets are improving. The ability of domestic borrowers, at least the stronger ones, to raise funds locally outside the banking system is fundamental so as to create a competitive credit market. Unfortunately, in the past, regulators paid too little attention to the local bond markets and too much to local equity markets, which are much more difficult to develop, given the culture of nondisclosure that is ingrained in what are essentially privately held companies. Other than the major banks and utilities, as well as a few major industrial companies such as cement producers, the vast majority of firms in Latin America are privately controlled. Raising equity capital through the public markets is therefore a difficult option, because it dilutes the controlling shareholders, who are permanently tempted to limit the rights of the minority public shareholders.

For these reasons, developing the domestic bond market is an essential first step in the construction of a local securities market. High levels of commercial and political risk in a number of countries mean that investors, whether private or institutional, are more likely to buy bonds than they are to buy shares, which in general are considered speculative. The basic ingredients needed to build up a domestic bond market are well known. As in banking reform, the five necessary steps are rather pedestrian but difficult to organize successfully.

The first step is *low inflation*. High and unpredictable rates of inflation introduce too much uncertainty, even if indexation can partially mitigate their effect. In Peru, for example, as inflation stayed at about 1 percent in the period 2000-02, the domestic bond market—which had been dormant for years—revived rapidly both for the major corporations and for the government. This heightened competition for the banks gradually spurred them to revive credit.



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**Table 5.4 Selected Latin American domestic bond markets, 2001**

| Country | Outstanding domestic public debt as a percent of GDP | Daily trading volume (millions of US dollars) | Tax treatment |
| --- | --- | --- | --- |
| Brazil | 53 | 400-500 | 15 percent withholding on interest and capital gains |
| Chile | 7 | Negligible | 4 percent withholding on interest |
| Mexico | 11 | 2,000 | No withholding; some exceptions |

*Source:* JPMorgan.

The second step is *credible and uniform accounting standards*. There is still far too much leeway in the reporting of basic financial information about the financial health of companies, which makes informed credit judgment difficult. The many subjects that need to be addressed include the rules for consolidation of subsidiaries, the accounting of leasing obligations and of contingent liabilities, and the role of treasury stock (often used as an undisclosed mechanism of control).

The third step is *a level regulatory and tax playing field among competing financial instruments*. In some countries, interest on government bonds is tax exempt to the recipient, increasing the cost of credit (on an equivalent after-tax basis to the lender) for private-sector borrowers. Other distortions include both preferential or discriminatory tax treatment for foreign holders and also regulations (modeled on the Basel standards) governing permissible holdings, which also often discriminate against private-sector issuers and give the illusion that government bonds are safer, when in fact in some cases (e.g., Argentina) the opposite may be true.

The fourth step is *motivated investors*. Here the most important development is private pension funds, which were discussed above. But other investors need to be encouraged by more modern investment regulations; this is particularly the case for insurance companies and for government surplus funds, which sometimes let their funds languish in savings accounts.

The fifth step is *liquidity*. This is a fundamental requirement, but it is hard to achieve in what are essentially small markets (table 5.4). The problem is sometimes exacerbated by a multiplicity of instruments: Brazil, for example, has five different types of short- and medium-term government notes, with a wide variety of maturities. In smaller markets, the lack of a benchmark government bond or note that is widely traded and recognized is an impediment to liquidity and tradability. Withholding taxes are also a deterrent to the development of bond markets, especially if they are high (table 5.4).



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**Table 5.5 Major Latin American equity markets, 1995 and 2001**

| Country and market | Dollar index, December 31, 2001 (December 31, 1995 = 100) | Average trading volume (millions of dollars per day) 1995 | 2001 |
|---|---|---|---|
| Argentina, Merval | 56.9 | 19.2 | 20.4 |
| Brazil, Bovespa | 132.4 | 209.2 | 220.4 |
| Chile, IPGA | 71.4 | 44.6 | 21.5 |
| Mexico, IPC | 192.5 | 137.7 | 152.7 |

*Source: Economática*, various issues.

If developing a domestic bond market is a challenging and complex task in Latin America, it is doubly so in the case of domestic equity markets (table 5.5). From 1989 to 1994, the heyday of Latin American financial recovery after the debt crisis, the main equity markets in the region averaged a compound annualized rate of return of about 25 percent, as noted above. From 1995 to 2001, however, the growth rate was negative, depending on how it was measured (an overall cumulative decline of 24 percent from May 1997 to May 2002—according to Bloomberg data).

Domestic bond markets in this latter period had a very low average annual return of 2.5 percent (Bloomberg data), partly because of financial crises in various countries; excluding Argentina, the return rises to about 8 percent, still a low number in relation to country risk. The paradox then is that equities showed low or no return but high risk; bonds, conversely, had lower risk and higher returns. The result has been a massive flight from Latin American equities by international investors, which in the early 1990s accounted for the bulk of trading and liquidity in domestic equity markets. Foreign portfolio investors had not returned as of 2002. Only one initial public offering of size has taken place locally in the past 5 years—that of Embraer, the Brazilian aircraft maker.

The depressing trend in the equity markets mirrors that of GDP, which grew only about 2 percent a year in the period 1995-2001, compared with about 4.5 percent in 1989-94. Only a sustained period of growth and especially the prospect of sustained growth—since the perception of the future is the key variable in equity markets—can brighten the gloom in local equity markets. Other changes would also help, particularly much greater transparency in the way companies deal with minority shareholders.

Despite much talk of minority rights and transparency, stock markets and their regulators in Latin America are known for their opacity and arcane rules. A lack of disclosure and insider trading are common occurrences. Such a setting is a major deterrent to international institutional investors, most of which are fiduciary institutions (with obligations to others, such as pensioners, shareholders, and endowments). Without institutional investors, it will be very difficult to restore vitality to domestic



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equity markets. This is where the development of domestic pension systems can over time play an essential role.

## Foreign Direct Investment

Most Latin American economies can expect to continue to be capital importers for a long time to come. But for some, particularly Chile and Mexico, their dependence on foreign capital is likely to decline fairly rapidly; their past problems of external debt are long gone. In both cases, interest payments on the external debt are just 7 percent of annual exports of goods and services. But for most of the other major economies, external debt is still a problem. In Brazil, for example, interest payments are 25 percent of exports of goods and services; the ratio of interest due in Argentina is even higher, at 38 percent. Other countries, such as Colombia and Peru, have more manageable debt-service burdens but still face heavy repayment maturities that reflect past fiscal deficits.

The bulk of the external debt of Latin America, about two-thirds of it, is owed by the public sector, much of it for deficit financing with no measurable impact on productivity or growth. The private-sector debt, other than self-liquidating trade lines, in large part reflects borrowing to finance specific investment projects, sponsored both by domestic and foreign investors. There is thus a significant amount of double counting in the debt and foreign direct investment statistics, because a part of the latter is financed by external borrowing. Unlike the public debt, however, the private debt is directly linked to cash flows that permit servicing the debt. In that sense, foreign direct investment, which acquired increasing importance in the 1990s (table 5.6), and the debt that partially finances it may well be more desirable than general-purpose public borrowing.

Latin America has had cyclical booms and busts in foreign direct investment, following trends in the world economy, in commodity prices, and in other factors during the 1990s, particularly privatization and the opening of trade. The 1920s was a period of record inflows, followed by drought in the 1930s and a new boom beginning with World War II that was followed by the heyday of import-substitution investment in the 1950s and 1960s. The 1970s was a period of record debt inflows, followed by a drought of loans and direct investment during most of the 1980s until the debt crisis started to recede in the late 1980s. Then in the 1990s foreign direct investment picked up strongly, stimulated by reforms in Argentina and Mexico, then by the impending accession of Mexico to the North American Free Trade Agreement, and finally by the large-scale privatization effort of Brazil in the second half of the decade.

Over the years, foreign domination of parts of the economy has been a subject for hot debate in a number of countries. From the 1950s to the



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**Table 5.6 Trends in foreign direct investment in selected Latin American countries, 1992-2001** (billions of US dollars at current prices)

| Country | 1992 | 1994 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001[a] |
|---|---|---|---|---|---|---|---|---|
| Argentina | 3.2 | 2.5 | 4.9 | 4.9 | 4.2 | 22.0 | 10.5 | 3.5 |
| Brazil | 1.9 | 2.0 | 11.7 | 18.6 | 29.2 | 28.6 | 30.5 | 19.0 |
| Chile | 0.5 | 1.7 | 3.4 | 3.4 | 1.8 | 4.4 | –1.1 | 0.9 |
| Colombia | 0.7 | 1.3 | 2.8 | 4.9 | 2.4 | 1.1 | 2.1 | 1.8 |
| Dominican Republic | 0.2 | 0.2 | 0.1 | 0.4 | 0.7 | 1.3 | 1.0 | 0.9 |
| Mexico | 4.4 | 11.0 | 9.2 | 12.8 | 11.3 | 11.6 | 13.2 | 24.5 |
| Panama | 0.1 | 0.4 | 0.4 | 1.3 | 1.2 | 0.6 | 0.6 | 0.3 |
| Peru | 0.2 | 3.1 | 3.2 | 1.7 | 1.9 | 2.0 | 0.6 | 1.0 |
| Venezuela | 0.5 | 0.1 | 1.7 | 5.0 | 4.2 | 2.0 | 4.4 | 2.5 |
| **Total for Latin America** | **12.5** | **23.7** | **39.4** | **55.6** | **61.6** | **77.0** | **64.8** | **58.3** |

a. Preliminary estimates.

*Source:* Economic Commission for Latin America and the Caribbean, *Statistical Yearbook 2000* and *Preliminary Overview of the Economies of Latin America and the Caribbean*, 2001.

1970s, most foreign-owned utilities were taken over by the state, partly for nationalistic reasons but also for practical reasons—principally that the multilateral development banks did not lend to private-sector entities, a policy that was broadly followed by international commercial banks in the lending boom of the 1970s and early 1980s.

The contribution of foreign direct investment to development and economic growth has been questioned, although often on unconvincing assumptions that fail to take into account other variables that also affect economic performance.[8] Certainly, despite the very high levels of foreign direct investment in the 1990s (averaging about 4 percent of GDP in the second half of the decade), economic performance was poor almost everywhere except Mexico.

But what would have happened if foreign direct investment had been sharply lower? Or is there some way, so far not explained, in which the effort of foreign investors somehow relieves locals promoting their own entrepreneurship? So far, these questions are in the realm of speculation.

For the immediate years ahead, however, there is little doubt that foreign direct investment will continue to be viewed as a key barometer of economic dynamism, whether as a cause or a reflection of it. There is also little doubt that a number of events will tend to depress foreign direct investment. First, the slow economic growth of most Latin American economies will be a damper, and a significant turnaround in growth will be nec-

8. A recent example of this discussion is Carkovic and Levine (2002). Also, the World Bank and other organizations sponsored a conference with the theme "Financial Globalization: Blessing or Curse?" in Washington on May 30-31, 2002.



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essary before perceptions improve. Second, the era of easy privatizations is over; a number of utilities overpaid for their Latin American assets in the 1990s, especially in telecommunications and electricity, and the remaining large potential privatizations are precisely in the utility field (generation in Brazil; generation and distribution in Mexico), where the major foreign players have mostly been badly burned. Third, the write-offs by foreign investors in Argentina (probably in the range of $20 billion to $25 billion, mostly in banks and utilities) are of such a magnitude that they have endangered the very survival of some of the companies involved, adding another major downward pressure on foreign direct investment.

To palliate the downward trend of the immediate years ahead, governments will need to do the same things to encourage foreign investment as they must do to promote domestic investment. The requirements are very much the same in both cases. Labor costs (see chapter 9) must become much more competitive internationally, by reducing the large burden of extra costs (particularly severance costs) that are not matched by corresponding levels of productivity. The same goes for infrastructure costs, although they have significantly improved, and credit costs, which the threat of inflation and a lack of competition keep high in several countries. Corruption, especially of administrative officials and judges, is also a major obstacle. Without lower costs and higher productivity, most Latin American economies cannot hope to be more than marginal players in the international economy.



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