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Key Macro-Financial Elements in the Development of

Central American Capital Markets:

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Introduction

This summary report draws upon the material already presented in the reports on macro-financial conditions in Costa Rica, El Salvador and Panama as these conditions impact on the development of capital markets in each of those countries.[1] As a consequence, the main purpose of this report to highlight the similarities and differences among the three countries that appear to have particular relevance for the development of capital markets in the Central American region.

What is perhaps most striking is the major differences among these three countries in their macro-financial conditions in spite of their physical proximity, their common histories and traditions, and their similar sizes and economic structures. For example, Costa Rica's efforts at financial reform have been continually impeded by large fiscal deficits, a large external debt and a financial system dominated by highly inefficient public-sector banks. Nonetheless, Costa Rica has by far the most developed securities market in the region. Panama, on the other hand, has a highly efficient banking system dominated by the private sector together with a reliance on the U.S. dollar for its currency that provides a major element of fiscal and financial stability. Nonetheless, Panama's formal securities market is largely inactive. El Salvador has passed through more than a decade of extreme internal political instability during which banks and many other major private-sector enterprises were nationalized, and it has no formal securities market. Nonetheless, El Salvador has largely avoided major fiscal deficits and excessive foreign debt and has recently moved to liberalize its foreign exchange and financial markets, including the reprivatization of its banks. Public response (i.e., the accumulation of domestic financial assets) suggests that this may be seen as a genuine "change in regimes" that could lay the basis for the rapid development of a significant securities market.

For each of the three Central American countries, the main macro-financial conditions to be surveyed in the summary report are:

- o the fiscal situation, including not only the central government but also the Central Bank and autonomous government agencies, as well as the financing of the deficit;

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[1]Eduardo Lizano and Robert C. Vogel, "Central American Capital Markets -- Costa Rica: Macro-Financial Background," IMCC, November 1991; Leonardo Auernheimer, "Central American Capital Markets -- El Salvador: Macro-Financial Background," IMCC, June 1991; and Roque Fernandez, Juan Carlos Protasi and Robert C. Vogel, "Central American Capital Markets -- Panama: Macro-Financial Background," IMCC, December 1991.

- changes in the foreign exchange regime and, briefly, the behavior of the exchange rate and the balance of payments;

- the behavior of monetary aggregates, inflation and interest rates, as well as changes in government monetary, credit and interest rate policies;

- instruments for carrying out monetary policy and for the further development of capital markets; and

- the effects of taxation on financial markets and instruments.

The Fiscal Deficit and its Financing

In any economy, the public-sector fiscal deficit is a crucial input for macro-financial stability in general and for the development of domestic capital markets in particular. Any fiscal deficit must be financed in some way, and the larger the deficit the greater the potential pressure on domestic financial markets. Even if a deficit can be financed externally, foreign borrowing must eventually be repaid, while foreign grants depend on a country's continuing ability and willingness to please external donors.

That part of the fiscal deficit that must be financed domestically can either be financed transparently (e.g., through the issue of securities that are purchased voluntarily by private-sector agents) or through various non-transparent means such as high reserve requirements on deposits at regulated financial institutions, forced purchases of government securities carrying below market rates of interest and/or rapid expansion of the monetary base to take advantage of the inflation tax. Non-transparent means tax and repress the formal financial system and are thus inconsistent with programs of financial reform and liberalization -- but are nonetheless widely employed, even by countries espousing programs of reform. The use of transparent means to finance a public-sector deficit can aid the development of domestic capital markets by providing a greater range and volume of securities to be traded, but even transparent financing cannot avoid crowding out credit to the private sector. Moreover, paying market rates of interest on outstanding government debt may further complicate a country's fiscal problems, especially if the interest rate is higher than the country's growth rate so that its deficit will tend to expand without limit unless it runs a primary surplus.

Costa Rica

The public-sector deficit has always been an important problem for the Costa Rican economy, especially in recent years. During the 1980s, with the exception only of 1988 and 1989, the global public-sector deficit was over 5 percent of GDP each year. There is a wide consensus that the Costa Rican fiscal deficit comes mainly from excessive expenditures instead of from a shortage of revenues. In fact, in comparison with the rest of Latin America, Costa Rica has a very high ratio of tax revenues to GDP, about 14 percent in 1990, with more than 15 percent expected for 1991.

The main sources of Costa Rica's fiscal deficits are the Central Government and the Central Bank. Certain structural problems promote automatic increases in government expenditures. In particular, there is a very complicated labor benefit schedule that automatically makes current government expenses grow. To some extent, moreover, public employee benefits are not under the control of the central executive authorities because, in practice, the court system is in charge of settling collective labor controversies. Furthermore, retirement benefits are excessive according to most standards and imply severe actuarial losses to the pension system.

Another structural problem comes from export promotion incentives. These appear to have been very effective in increasing Costa Rican sales to other countries, but at the same time they have been very costly to the national budget. One of the most disturbing items among expenditures is the increase in interest on the public debt. In 1991, contractual interest payments by the Government accounted for almost one-third of total budget provisions. This is especially troubling because it is due in part to the process of financial liberalization which involves moving toward the payment of market rates of interest on the public debt.

The second major source of public-sector budgetary imbalance is the Central Bank. After 1981, Central Bank losses began to increase rapidly as a result of the sharp expansion in public-sector foreign debt. The Central Bank itself had in the past incurred major foreign indebtedness to sustain a fixed exchange rate. In addition, the Central Government and other public agencies further augmented the Central Bank's external debt, as the Central Bank had to make external payments to creditors while local debtors were responsible only for paying the Central Bank in local currency. These operations resulted in significant exchange rate losses. Furthermore, Central Bank losses have progressively increased as a consequence of increasing interest payments on Stabilization Bonds (financial instruments aimed at controlling monetary expansion) and Foreign Currency Certificates (bonds denominated in foreign currency) due to higher interest rates and the continuing accumulation of these Central Bank instruments in the hands of the general public.

Public-sector enterprises are a source of budget surpluses that help to offset a part of the deficits from the Central Government and the Central Bank. Some public enterprises, such as the Costa Rican Water and Sewage Institute (ICAA), the Railroad Company (INCOFER), the National Production Council (CNP) and most of CODESA's enterprises, have chronically unbalanced budgets. Others, however, such as the Costa Rican Electric and Telephone Institute (ICE) and the Costa Rican Petroleum Refinery (RECOPE) have traditionally run huge financial surpluses. For this reason, public enterprises as a whole have shown significant surpluses every year since 1986.

Another traditional source of budget surpluses in Costa Rica has been the "rest of the non-financial public sector," which includes most of the decentralized public institutions such as the Social Security System (CCSS), the Agrarian Development Institute (IDA), and the Costa Rican Coffee Institute (ICAFE), among others. Usually the most important source of this surplus is the CCSS which, in 1990, generated more than 60 percent of the total surplus of this group of governmental institutions.

The financing of public sector deficits has traditionally been transparent. The main sources of funds have been the sale of government bonds to the public through open market operations on the National Securities Exchange and credit from the banking system. In addition, government bonds are placed directly with certain public sector entities as a means to balance the overall deficit. In recent years, the most important source of financing for the fiscal deficit has been the issue of Government Bonds which, in 1990, financed 87 percent of the deficit. Most of these bonds are sold to "the rest of the non-financial public sector (47 percent in 1989) and the banking system (16 percent in 1989), while the private sector bought 21 percent of the net increase in bonds during 1989.

The increasing placement of public debt issues creates significant pressures on financial markets, thereby increasing interest rates in real terms. These pressures produce a significant crowding out of the private sector because investors cannot compete with the Government for the scarce funds available. The placement of bonds with other public sector entities does not resolve this problem and may be especially detrimental to the development of Costa Rican capital markets not only because these transactions may not be carried out on the National Securities Exchange but also because potentially long-term funds, such as those from the CCSS, are thereby absorbed.

El Salvador

Unlike many other Latin American countries, the fiscal deficit in El Salvador has not usually been the basic source of economic instability. For the most part, the long-term deterioration in El Salvador's tax revenues has been met with expenditure reductions. While this has helped to avert macro-economic instability, it has often come at the cost of cutting outlays for which reductions are easiest in the short run but most costly in the long run (e.g., infrastructure, health, education and other items of government capital formation). Comparison with other Latin American countries suggests that any deficit reduction strategy for El Salvador should focus on increased tax revenues, involving both better laws and improved administration, together with a change in the mix of expenditures, rather than a reduction in overall expenditures.

With respect to El Salvador's overall deficit, several other points should be noted. First, both revenues and expenditures have fallen relative to GDP during the last five years, except for 1988 when expenditures increased slightly. Second, the central government, and not the rest of the non-financial pubic sector, has been responsible for the deficit; in fact, non-financial public enterprises have generally shown a surplus. Third, efforts are to be made to increase revenues through improved tax administration and the introduction of a value-added tax. Fourth, government expenditures on physical capital were unusually high in 1986 as a reflection of earthquake reconstruction, but this does not explain the fall in other components of public investment. Fifth, defense expenditures have risen during the period of internal conflict, while public sector wages and salaries have generally fallen in real terms, thereby lessening the ability of the government to attract and retain skilled personnel.

Domestic financing of the public sector deficit has generally been small, not only because of the small size of the deficit itself but also because of substantial external funding. As a result, El Salvador's internal debt is small -- only 9.3 percent of GDP as of 1990, including all debt issued or guaranteed by the public sector, of which about half is Financial Stabilization Bonds issued by the Central Bank. Nonetheless, the program to recapitalize public sector commercial banks and savings and loan associations before their privatization could add substantially to the debt of the Central Bank. In any case, El Salvador does not appear to face the problem of many Latin American countries, including Costa Rica, that increased interest payments on public sector debt as part of financial liberalization could lead to severe threats of macro-economic instability. Moreover, the Central Bank's Financial Stabilization Bonds, together with the bonds to be issued as part of the recapitalization program, could provide an attractive array of instruments to be traded on a formal securities exchange without serious crowding out of private sector financing.

Panama

During the 1980s most Central American countries tended to decrease their public expenditures in real terms due to external restrictions against increased foreign indebtedness, but Panama was an exception until 1987 as foreign indebtedness continued to be the main source that allowed a high level of government spending to be maintained. During 1988 and 1989, however, the precarious political, and hence financial, situation of the country meant that drastic reductions in government expenditures had to be undertaken; but this was not an easy task, and in many cases government expenditures were financed by accumulating debts to local suppliers and by not paying public agencies for services provided.

At the beginning of 1990, the new Panamanian Government imposed temporary expenditure ceilings to gain time to prepare a budget. These ceilings, together with higher government revenues -- mostly due to the lifting of economic sanctions -- resulted in a significant improvement in public finances. This improvement in turn permitted a decline in net credit from the National Bank of Panama (BNP) to the nonfinancial public sector. A significant part of the improvement in the fiscal situation was due to the resumption of payments from the Panama Canal Commission, which allowed 1990 government outlays to be funded without a large increase in tax revenues. Since part of the 1990 payments from the Canal Commission were for arrearages, and hence are an extraordinary source of revenue that will not be available in future years, there is need for a significant increase in tax revenues, especially since an increase in government indebtedness is not possible (and would not be advisable even if it were possible).

Current outlays of the Panamanian Government declined in 1990, mostly as a consequence of a reduction in the wage bill and other current outlays that more than compensated for the increase in purchases of goods and nonpersonal services. In addition, the Government of Panama developed an IMF-monitored program with the intention of beginning to normalize its relationships with international financial institutions and other external creditors. This program included a reduction of the nonfinancial public sector deficit from 11 percent of GDP in 1988-89 to 7 percent in 1990 and to about 5 percent in 1991. This fiscal adjustment is to be achieved through continuing improvements in public sector revenues and sustained restraint in current expenditures. Public sector revenues are estimated to have increased from an average of 24 percent of GDP in 1988-89 to about 27 percent in 1990 and 28 percent in 1991. Current expenditures are estimated to have declined from an average of about 34 percent in 1988-89 to 31.5 in 1990 and to about 30 percent in 1991.

The 1988-89 crisis sharply reduced revenues from United States owned corporations and from the Panama Canal. In spite of reductions in public expenditures, public sector savings became negative, and there was a systematic reduction in the availability of resources for public investment. As the Panamanian Government does not have the ability to levy an inflation tax, and foreign credit was simultaneously restrained, the increased public sector deficit had to be financed by: (1) the accumulation of foreign and domestic debt service arrears; (2) increased borrowing from the BNP; and (3) payments arrears to domestic suppliers, a mechanism through which the public sector forced the private sector to save to compensate for public dissaving.

Financing of the deficit for 1990 was covered by the use of unblocked funds, a portion of the United States aid package, a rescheduling of interest obligations in the context of the Paris Club, and the accumulation of external interest arrears to commercial banks and other non-guaranteed debt to private creditors. To finance its investment program, the Panamanian Government has traditionally turned to international and bilateral lending agencies and the Eurocredit market. Public utilities and large companies have not issued securities because many of them are government owned or closely held and also because of the lack of a domestic securities market. The absence of such a market, together with the openness of the financial system, has left the Panamanian Government with few instruments for domestic financing of the government.

An important source of government finance in many countries is to increase reserve requirements on the banking system. In countries with fiat money this is usually done in the following way. First, the central bank issues money to finance the government, and then, to inhibit the acceleration of inflation, the central bank increases reserve requirements to sterilize the monetary expansion. Another way of doing the same thing is first to introduce an increase in reserve requirements and then to allow special government debt instruments to be counted as part of required reserves. In Panama, reserve requirements cannot be used to sterilize increases in credit to the government because the openness of the financial system would jeopardize the existence of Panamanian banks. Reserve requirements higher than international standards would make it impossible for Panamanian banks to compete because higher reserve requirements imply higher spreads.

Since the Panamanian Government cannot print money, it cannot collect seigniorage or inflation tax revenues to finance its fiscal deficit. The public sector deficit has to be financed either by raising taxes or by issuing public debt, either domestic -- such as government bonds, loans from the BNP or arrearages (floating debt) to government suppliers -- or foreign with international donors or commercial banks. Wealth holdings in domestic financial instruments cannot be taxed through the inflation tax, as happens so often in most other Latin American countries. This is an important advantage for capital market development. Nonetheless, Panamanian financial instruments are heavily taxed through the income tax, as discussed more fully in later sections of this report.

The Foreign Exchange Regime

Consideration of the exchange rate and the foreign exchange regime is essential for an adequate understanding of the macro-financial situation in any country, as well as of the prospects for capital market development. An over-valued exchange rate creates expectations of devaluation in a fixed-rate regime and of depreciation of the domestic currency in a floating-rate regime. In either case, economic agents will find it less attractive to hold assets denominated in the domestic currency and will, therefore, require higher rates of interest on bank deposits and on debt instruments traded in domestic capital markets. The result will be higher interest rates for borrowers and a reduction in the real size of the banking system and domestic capital markets.

The choice between a fixed-rate regime and a floating-rate regime is a much debated topic in economic literature for both developed and developing countries. Nonetheless, a consensus has emerged that, under either type of regime, it is usually a mistake to impose foreign exchange controls such as requiring exporters to surrender foreign exchange earnings or importers to purchase foreign exchange only through official channels. Such controls are not only very difficult to enforce but also discourage economic agents from holding domestic assets because of fears that it may suddenly become more difficult to convert these assets to foreign exchange when needed. Although many countries have such controls (usually stemming from attempts to maintain an over-valued exchange rate), foreign exchange controls -- like an over-valued exchange rate -- penalize the holding of bank deposits and domestic debt instruments and thereby impede the development of the banking system and domestic capital markets.

Costa Rica

Costa Rica has experienced intense exchange rate problems during the past decade, and this exchange rate instability has come primarily from fiscal disequilibria. The Government has frequently resorted to the banking system, seeking funds to finance its deficits. The Central Bank has then had to increase the amount of credit available to the banking system and, with this support, the banking system has provided the necessary funds to the Government. This situation has produced monetary disequilibria that have weakened the balance of payments and increased domestic inflation and thereby distorted the nominal exchange rate.

After the severe 1980-82 crisis, Costa Rica adopted a more flexible exchange rate policy. Initially this was just a system of periodic devaluations in response to specific circumstances, but in 1985 the Central Bank implemented a more formal crawling peg policy. The basic rule of this policy was to compensate for the difference between the domestic inflation rate and a weighted average of the inflation rates of Costa Rica's major trading partners. However, the authorities have not always strictly followed this policy, and the real exchange rate has frequently become overvalued relative to the U.S. dollar. In fact, the overvaluation of the Costa Rican colon -- and the resulting loss of export competitiveness -- may have been one of the main reasons for the deterioration in the balance of payments experienced during the last two years. Costa

Rica's real exchange rate experienced a major appreciation during the last two years, at least until August 1990. After that date, the Central Bank substantially accelerated the weekly rate of devaluation. The more rapid pace of devaluation led to a readjustment in the real exchange rate, but not by enough to return the index to its level of January 1987.

The major components of the current account of Costa Rica's balance of payments deteriorated in 1989 after several years of sustained improvement. The deficit in the trade balance doubled in 1989 with respect to 1988, and in 1990 it doubled again. The trade balance deteriorated mainly as a result of a rapid increase of imports in 1989. In 1990 not only did imports continue to grow rapidly, but exports also became much less dynamic. Both events, the increase of imports and the sluggishness of exports, are at least partially consequences of the local currency overvaluation. The worsening of the trade balance (the deficit increased from US$165 million in 1988 to US$590 million in 1990) together with a significant reduction in official capital inflows (such inflows, including both loans and official transfers, decreased from US$312 million in 1988 to US$261 million in 1990) produced a sharp fall in the international reserves of the banking system (-US$285 million). This caused an increase in external arrearages and in the availability of foreign exchange for imports and other external payments.

Although the Central Bank formally maintains a monopoly over all foreign exchange reserves, in practice there have not been tight controls on the functioning of the parallel foreign exchange market. While there has been significant foreign exchange scarcity in the banking system for over a year, the parallel market has not reflected any significant pressure. In fact, the gap between the banking system exchange rate and the parallel exchange rate was less than 3 percent early in 1991 and reached at most 6 percent during 1990 and then only for very short periods of time.

The dichotomy between the official and parallel markets reveals how difficult it is to enforce capital controls in Costa Rica. In fact, the existence of an official "dollarized" component of the financial system prevents the authorities from having any kind of effective jurisdiction. With increasing dollarization, the Costa Rican financial system becomes more integrated into world financial markets, so that the Central Bank has less control over the domestic financial system and must, in particular, continually take into account the effect of its monetary and interest rates policies on the possible transfer of colon-denominated financial assets into dollars. At the end of 1990, Costa Ricans had time deposits in the banking system denominated in foreign currency that amounted US$566 millions. In addition, a portion of the credit operations of the financial system are conducted in foreign currency. The Central Bank also has an Official Capital Register for investors bringing external capital into the country. Registration guarantees that, after a 5 year period, the Central Bank will provide foreign exchange at the official exchange rate for interest, royalty and dividend payments as well as for capital repatriation.

The current situation suggests that, in the near future, Costa Rica may need to consider total exchange rate openness, leaving both trade and capital operations to a free parallel market. Although this often appears risky in countries such as Costa Rica that have not been able to achieve satisfactory internal and external stability, it may nonetheless be advantageous to have a parallel foreign exchange market that is totally free from possible vagaries in Central Bank exchange control policies. This may be even imperative considering the major constraint that Costa Rica's external debt imposes on its financing of any gap in the balance of payments. Currently, Costa Rica has an external debt that amounts to more than US$3,000 million. Under present contractual terms, the country needs more than $220 million for interest payments and about $250 millions for principal payments on the external debt each year. Debt service required almost one third of total export proceeds in 1990.

El Salvador

Like most other Central American countries, El Salvador had, until late 1985, a long tradition of exchange rate stability under a fixed rate regime. However, the major devaluation at the end of that year (to 5 colons to the U.S. dollar) was followed in 1989 by the adoption of a floating rate regime by the new government. Although exchange controls were temporarily reimposed in March 1990, following the guerrilla offensive of November 1989 and a subsequent loosening of monetary policy in response to a run on the banking system, controls were eliminated in May 1990 and the rules of the current regime were established.

Under this regime, there are basically two foreign exchange markets, in addition to the participation of the Central Bank. The bank market is for trade account items, except coffee and petroleum, although importers are under no obligation to purchase their foreign exchange in this market. This is also the market for Central Bank intervention to smooth out transitory disequilibria. The exchange house market, which captured the "black market" that existed until liberalization in May 1990, handles about 20 percent of foreign exchange transactions, including remittances and purchases for travel and study abroad, imports not covered in the bank market and miscellaneous transactions. There are about 50 exchange houses, some of which are owned by commercial banks, with 70 branches located throughout the country. Central Bank participation mainly involves the purchase of foreign exchange from coffee exports and receipts from official transfers and public sector loan disbursements and sales for petroleum imports, public sector imports and payment of external debt. The "official" exchange rate is determined weekly as the simple average of the rates in the bank and exchange house markets during the preceding week.

This foreign exchange regime, together with the freedom of importers and exporters to maintain U. S. dollar deposits and the absence of any effective restrictions on capital movements, has led to basic stability in the exchange rate in spite of continuing internal conflict. Moreover, the gap between the rates in the two markets has become negligible over time. However, for continuing rationality of monetary and exchange rate policies, government policymakers must continue to recognize the fundamental economic principle that it is impossible to influence independently both the nominal exchange rate and nominal monetary aggregates. In addition, under no circumstances is it possible to influence the real exchange rate by manipulating a nominal variable, except for very short periods of time. The behavior of real exchange rates is a complex and not well understood phenomenon, but in no case can the control of a nominal variable allow the determination of a real one.

Trade liberalization, in addition to the liberalization of the foreign exchange regime discussed above, has allowed El Salvador to increase both its exports and its imports substantially in real terms. Although as a result the trade balance worsened slightly in 1990, this was more than compensated by net transfers -- not official grants and foreign government transfers, which declined, but rather private transfers which increased by almost 30 percent. In addition, private capital inflows increased dramatically in response to greater confidence in the new government and its policies, thereby allowing a substantial increase in foreign exchange reserves. Thus, El Salvador's balance of payments (including its external debt) does not appear to present an obstacle to continuing trade liberalization or to the development of a formal domestic securities market.

Panama

Panama's Constitution forbids the issuance of fiat money as legal tender. The Balboa is the national currency that circulates only in the form of coins, while the U. S. dollar circulates as paper money and is used as the unit of account for both domestic and external payments. There is no exchange rate policy other than maintaining the convertibility of coins in agreement with the Constitution. Trade with the rest of the world is mostly carried out in United States dollars, but under a system where import protection and export promotion prevail in almost every sector of the economy.

Protection for domestic agriculture and manufacturing is high on the average, as is the dispersion of tariffs. According to World Bank estimates, the unweighted average tariff in Panama is about 33 percent, with maximum tariff rates reaching 270.5 percent for agriculture and 257.5 percent for manufacturing. Tariff rates can be even higher in some case as specific tariffs may be substituted rather arbitrarily for ad valorem tariffs. In addition, tariffs on consumer goods are higher than those on intermediate goods, and these in turn are higher than tariffs on capital goods. Production-weighted nominal protection of manufacturing is well above unweighted protection and, together with tariff exemptions on inputs, establishes high rates of effective protection for import substitution industries. In fact, the production-weighted average tariff is 67 percent, while the import-weighted tariff is only 25 percent. In addition, agricultural products such as rice, corn, onions, milk, butter and vegetable oils are subject to quota systems that further restrict trade.

Non-traditional exports, as well as fruits and vegetables, fall under special promotion laws that fully exempt inputs from import tariffs. These products are also exempted from corporate income taxes, production taxes, sales taxes, and taxes on assets. In addition, Tax Credit Certificates, equal to 20 percent of the value of export production, are given to firms with domestic content of at least 20 percent of manufacturing costs and domestic value added of at least 20 percent of the value of production. In spite of several decades of such policies of export promotion -- attempting to compensate for policies of import substitution -- the non-traditional sector remains small, accounting for only about 9 percent of total exports of goods and services.

The Panamanian case is not fully consistent with capital market development, as freedom of capital flows is not sufficient for total mobility of goods and factors. The inconsistency between capital market integration and high trade barriers undermines the growth potential of the productive sectors -- and these productive sectors should be the leading providers of instruments to be traded in Panamanian securities markets.

As a small open economy, Panama should grow not only on the basis of its service sector (e.g., commercial and banking services associated with the Panama Canal) but also by developing its tradeable export sector. Prices, as signals for allocating resources in an economy, are the same as international prices, except for the tariff regime. However, the prices of non-tradeables are increased by high tariff protection, so that inflation can deviate from the rate in the United States and the real exchange rate can be affected. Accordingly, the production of tradeables is discouraged by high import tariffs, while exports cannot be stimulated through a higher real exchange rate because the lack of monetary autonomy does not permit devaluation.

Inflation, Interest Rate Policies, and Domestic Credit Policies

Domestic capital markets are impacted in a number of significant ways by inflation, interest rate policies and domestic credit policies. Inflation in itself does not necessarily impede the development of capital markets, but the uncertainty that surrounds expectations of future inflation in countries with anything more than moderate inflation tends to make it quite difficult for borrowers and lenders to agree on interest rates for longer term contracts. Contracts with variable interest rates may solve some of these problems, but only if some reference rate can be agreed on and only if borrowers and lenders do not need to know future nominal cash flows with a high degree of certainty. The more problematic aspects of inflation arise when governments attempt to deal with inflation by introducing various types of controls that distort relative prices and thereby undermine the ability of economic agents to predict the relative profitability of different activities.

The most common government policies that influence the development of capital markets, especially in the context of inflation, are interest rate policies. Controlling nominal interest rates under situations of high and variable inflation is likely to make real interest rates unpredictable and possibly far from equilibrium levels for extended periods of time. If interest rate controls are applied to capital market instruments, this is likely to distort the development of capital markets. However, if such controls are applied only to regulated financial intermediaries (e.g., banks) or are universally applied but can more easily be evaded in capital market transactions than in transactions involving regulated intermediaries, capital market development may in fact be promoted through the greater opportunities for regulatory avoidance. Nonetheless, capital market development under such circumstances may lead to a lack of transparency as effective interest rates on transactions in capital markets are disguised.

Domestic credit policies can also distort the development of capital markets, especially if, as is typical, they involve the provision of central bank funds for longer term loans at below market interest rates based on the assumption that longer term funds will otherwise be unavailable. Assumptions of this type often become self-fulfilling prophesies, as prime borrowers gravitate to these subsidized funds, thereby reducing the demand for longer term loans at market rates of interest and thus impeding the development of competitive capital markets. At the same time, financial intermediaries with access to these subsidized central bank funds will not be inclined to pay the market rates of interest required to mobilize longer term funds in the open market. In addition, governments are often tempted to tap the funds generated by insurance and pension funds to deal with their fiscal problems, with the result that the main potential sources of longer term funds that could flow to domestic capital markets are instead absorbed to finance government fiscal deficits.

Costa Rica

In Costa Rica, average inflation rates have been quite high during the last four years, ranging from 16 to 21 percent as measured by the consumer price index. Lack of discipline in the control of monetary and fiscal variables has been the main cause of this price instability. However, the impact of domestic monetary disequilibria on Costa Rican inflation has been less important than their effects on the main external variables. In fact, these disequilibria have mainly affected the balance of payments by inducing increased imports. Part of this negative effect has been offset by the nominal devaluation of the exchange rate, which then produces price increases, but as already indicated the devaluation adjustment may have been insufficient.

The Costa Rican economy is small and open, and this openness produces the result that monetary disequilibria pressure the external balance more than domestic prices. This is the main reason that the exchange rate has to be adjusted frequently according to the difference between external and internal rates of inflation. An example of this is the experience of 1990. The money supply increased only 7.2 percent, while the inflation rate, as measured by the consumer price index, was 27.3 percent. The apparent insignificance of the increase in the money supply does not mean that there was not a monetary disequilibrium, but rather it shows the effects of the loss of international reserves. As the Central Bank expanded domestic credit, economic agents used the resulting expansion of the money supply to purchase foreign currency, thereby offsetting most of the increase in the money supply. In fact, the loss of international reserves was US$285 million, a record reserve loss for a single year.

One of the important consequences of inflation is its effects on nominal interest rates. These rates have increased substantially during the last three years, and this effect has been especially important since the second half of 1990. For many years, interest rates in Costa Rica were set directly by Central Bank authorities without any consideration of what market rates might be. Credit policy was consequently based exclusively on quantitative and qualitative controls, and interest rates on loans did not play any significant role in allocating funds to investment projects according to efficiency considerations.

Since 1986, however, the Central Bank has followed a more market oriented policy of interest rate determination and has given progressively greater autonomy to banks in the allocation of funds and the determination of interest rates. In 1988, moreover, a major financial reform was initiated, and a process of complete interest rate liberalization began. Private banks could then assume a more active role in interest rate determination, as they were permitted to charge and pay market rates.

During 1989 interest rates on both loans and deposits fluctuated in a narrow range, thereby making the differentials between state owned banks and private banks especially clear. Interest rates for term deposits of private banks are typically higher than those paid by stated owned banks due to the perceived greater riskiness of private banks, while for finance companies (both regulated and non-regulated) deposit rates are reported to range even higher. Interest rates charged by private banks show almost no variation among different categories of loans, but range between 5 and 10 percentage points higher than the rates charged by state owned banks for the same categories. It is said, however, that the lower interest rates charged by the state owned banks tend to be offset by poorer service (e.g., longer delays) and by the costs incurred by borrowers in securing loans (e.g., in obtaining required documents and in making more trips to the bank).

In recent years, both nominal and real interest rates have been increasing substantially. These increases are caused by several factors. Most importantly, the government has continually been resorting to open market operations with the selling of significant amounts of securities to fill its financing gaps and with the Central Bank also selling "bonos de estabilizacion monetaria," thereby competing not only with the private sector but also with each other to capture the public's savings. These competing sales have not only increased the demand for savings but may also have created a speculative trend in interest rates.

The need of the Central Bank to capture increasing amounts of short term deposits in order to sterilize the perverse effects of fiscal imbalances have pushed short term interest rates upwards. Until recently, the difference between interest rates on six month deposits and one month deposits has typically been over 9 percentage points, but lately the difference has virtually disappeared. This result is a direct consequence of the aggressive monetary policy pursued by Central Bank to control the money supply. While this policy has been effective in reducing excesses in the money supply, it has also been caused serious distortions in the term structure of financial markets. High short term interest rates, together with exchange rate risks and credit tightness, have greatly increases firms' preferences for short term financial assets.

Another important source of pressure on interest rates is the more dynamic and predictable devaluation policy implemented by Central Bank. This practice has impacted colon interest rates significantly, as people can easily move their savings from domestic financial assets to those denominated in foreign currencies. In order to remain competitive, the Costa Rican banking system has had to offer depositors highly positive real interest rates to make up for both the risk of devaluation and the interest rates paid on foreign currency deposits. This is also one of the reasons that foreign currency deposits in the banking system have been increasing more rapidly than local currency deposits. even though real interest rates on colon denominated deposits are positive.

Credit policy has been constrained by fiscal needs and monetary controls. As the government has taken a larger share of the additional funds available for lending, the private sector has been crowded out from financial markets and its potential for investment has thereby been restricted. Even in 1988 and 1989, when the increase in credit to the private sector was greater than the increase to the public sector, the overall increase in domestic credit was so tightly controlled that the increase in credit to the private sector was lower than in 1987 and 1990. In fact, total credit has expanded by less than the rate of inflation since 1987.

El Salvador

The inflation rate is a basic yardstick for the measurement of monetary policy performance, especially in a floating exchange rate economy such as El Salvador now is. Before discussing its ultimate causes, the monetary aggregates, it is helpful to examine briefly the recent behavior of inflation (as measured by changes in the CPI over 12 months). After many years of price stability based on a rather strict adherence to the rules of a fixed exchange rate system, the first devaluation took place at the end of 1985, following several years of balance of payments problems, a segmentation of foreign exchange markets and increasing exchange controls. During that year, the inflation rate rose from 12 percent to almost 35 percent. After peaking in mid-1986, there was a gradual decrease to around 15 percent by mid-1989, largely due to the imposition of various controls. With the immediate elimination of price controls by the new administration in June 1989, the inflation rate rose 5 percentage points in one month to 20 percent per year. Following the November 1989 offensive and a temporary increase in liquidity, it reached a peak of almost 30 per cent in early 1990, but since then has been declining persistently, to about 15 percent by early 1991.

Under a fixed exchange rate system, the monetary authority does not control the monetary base, but one of its components, the stock of domestic assets. The level of the other component, foreign assets, adjusts to keep the base at the level desired by the public, so that monetary aggregates are ultimately not determined by the monetary authority. Under a free floating system, as in El Salvador since 1989, the monetary authority recovers control of the monetary base and, together with the banking system, determines the stock of the other monetary aggregates. The basic change in regimes to a floating exchange rate system, together with increasing fiscal discipline, makes it particularly important to concentrate on events since 1989 relative to what took place before. Nonetheless, in El Salvador the Central Bank is still an important participant in the market for foreign exchange, so that the level of its international reserves is an important counterpart to the level of the monetary base, which the Central Bank can control as it does the level of domestic assets.

During 1990, domestic credit provided by the Central Bank rose only 12 percent in nominal terms, and decreased in real terms, reflecting the tightness of the monetary program. However, the monetary base (bank reserves plus currency in circulation) rose by 44 percent as the result of a substantial increase in international reserves. If the monetary base is taken as the variable that the monetary authority can most directly control under a system of floating exchange rates, and the one that will ultimately influence the level of prices, then the conclusion is that monetary policy has not been stringent as the numbers for domestic assets suggest.

Deposits in the hands of the public grew impressively during 1990, with demand deposits increasing by 40 per cent (18 per cent in real terms) and savings and time deposits by 32 per cent (10.3 per cent in real terms). Although both represent monetization, they clearly respond to different causes: the first, to an anticipation of a fall in inflation and thus in nominal interest rates and the cost of holding money; and, the second, to the increase in real interest rates brought about by the upward adjustments in the rates controlled by the monetary authority.

The relationship between monetary aggregates and prices is particularly complex at this point in El Salvador and will continue to be so if the inflation rate falls substantially. A fall in the inflation rate that is perceived as permanent by the public leads to a higher level of real money balances, so that monetary aggregates can rise for some time at a rate higher than the rate of inflation. Thus, the usual connection between the level of monetary aggregates and prices (and between the rate of growth of those aggregates and the inflation rate) breaks down transitorily. Moreover, the government can appropriate a once-and-for-all stock of resources from the private sector equal to the once-and-for-all increase in the monetary base. Moreover, when stabilization (i.e., a permanent fall in the inflation rate) is accompanied by structural changes that raise the anticipated real interest rate, as in the case of El Salvador, there is also an increase in time and savings deposits that will also allow the Central Bank to acquire resources commensurate with the required reserves on those deposits. Nonetheless, these changes are once-and-for-all changes, and the nominal base cannot keep increasing beyond some point without reviving inflationary expectations and endangering the stabilization effort.

Following the nationalization of El Salvador's commercial banks a decade ago, the new administration found an institutional financial sector characterized by a multitude of selective credit (rediscount) lines, a major erosion in bank assets (with 37 percent of assets deemed unrecoverable or difficult to recover) and interest rates controlled at levels consistently resulting in negative real rates ex-post.

After some technical studies, the new government decided to liquidate three of the nine banks and recapitalize the other six with a merger of two of them. In November 1990, legislation was approved for a restructuring of the Superintendency of Banks, a recapitalization and/or liquidation of the banks and savings and loans associations, and a process for privatization. The reorganization of the Superintendency of Banks provides for independence from the Central Bank, both legal and financial. The recapitalization of commercial banks takes the form of acquisition by the Central Bank of the non-performing portfolios of the commercial banks (and the savings and loans associations) in exchange for their existing debts to the Central Bank plus bonds to be issued by the Central Bank with ten years maturity and a variable interest rate equal to the six month deposit rate plus two percentage points. The objective is to attain for each institution a minimum net worth of 10 percent of the value of its assets before it is sold.

The legal framework for the privatization process, to take place only after the recapitalization process has been completed, establishes stringent limits on ownership -- no person can own more than 5 percent of a bank's shares (20 percent for multilateral international institutions). Although the limitation is addressed to avoid possible concentration of ownership and to deflect potential political problems, it clearly decreases the attractiveness of ownership and may thus result in a lower sales price than otherwise could have been obtained. Another feature of the privatization process is that bank employees and small investors can exercise a first-option right to purchase shares for a period of 120 days after the sale offer, with small shareholders having access to credit up to 100,000 colones using the shares as collateral.

Another important objective of the new administration has been the elimination of the large number of special credit (rediscount) lines. Many have already been eliminated, and others unified in a single rediscount line. A January 1991 directive of the Central Bank establishes a new system of rates applicable to loans granted by that institution: (1) all loans to the public sector will pay the basic bank loan rate; (2) for loans for the harvest of coffee and sugar cane the final borrower will pay 22 percent and the financial intermediary 19 percent, and for loans for other crops rates will be 20 and 17 percent, respectively, while commercial banks will pay a rate for stabilization loans two percentage points above the basic bank loan rate; and (3) in the longer term the objective is a single rediscount rate similar to the basic bank deposit rate. In addition, a condition for release of the second tranche of the World Bank's SAL is the unification of all short-term credit lines at a rate no less than the market rate on three months commercial bank deposits.

With the exception of the interbank interest rate, bank loan and deposit rates in El Salvador are still controlled by the Central Bank. In deciding the level of rates, the Central Bank's main concern has been to reverse the previous situation in which the low level of nominal rates consistently resulted in negative ex-post real rates. The January 1991 directive on interest rate policy involves a gradual adjustment toward total liberalization which is scheduled to take place in January 1993. The operational counterpart is the establishment of a band between the basic deposit rate and the basic loan rate, with revisions to take place at three fixed dates, followed by total liberalization in January 1993.

The predominant concern of the monetary authority has been to avoid the previous situation of persistently negative real interest rates which discouraged savings and forced credit rationing. The present scheme has the potential danger of causing the reverse problem with consequences that can be severe and lasting. The new rules for setting interest rates rely on past information (the inflation rate during a past number of periods) together with an undefined forecast by government. There are several reasons why this is a deficient mechanism, but especially to the extent that the rules rely on the behavior of past inflation, there is a danger of significant errors when there are reasons to expect a change in the trend of the inflation rate. In particular, it is the declared purpose of the monetary policy of the Central Bank, whose credibility is currently very high, that the inflation rate will fall in the near future. Rules based on past inflation rate thus present the danger of unduly high ex-post real interest rates. Even a relatively short period of excessively high ex-post real interest rates could have serious adverse effects by aggravating the precarious portfolios of the banks and placing otherwise viable business firms in a difficult financial situation.

<u>Panama</u>

By Latin American standards, Panama is one of the most stable countries due to its particular currency system, based on free circulation of the U. S. dollar. During the period 1975-90, the average annual inflation rate was 3.2 percent for the consumer price index and 6.4 percent for the wholesale price index. Most of the variation in the price level is related to changes in international prices and, secondarily, to changes in commercial policy that result in variations in the prices of both traded and non-traded goods from international prices.

The openness of the Panamanian financial system has ensured liberal interest rate policies to allow Panamanian banks to compete in deposit and credit markets. However, some restrictions exist: (1) interest on demand deposits is prohibited; and (2) savings deposits below US$3,000 have interest rate ceilings of 4.5 percent for commercial banks and 5.5 percent for saving banks. Interest rates on time deposits and loans are uncontrolled, and deposit rates are closely related to LIBOR. Credit is largely allocated according to market signals instead of a regulatory framework. Panamanian Governments have, however, attempted to direct credit to priority sectors with special programs for housing and agriculture at subsidized interest rates (about half the market lending rate) with the subsidy being financed by a levy of 1 percentage point on domestic consumer and commercial loans.

One great advantage of Panama's currency system is that it provides an effective constraint on the government's ability to finance the non-financial public sector deficit through money creation. Chronic inflation in most developing countries is fundamentally a monetary phenomenon resulting from central bank financing of government deficits. The existence of fiat money allows the central bank to print what is necessary to provide "advances" to the treasury, and this transitory financing almost inevitably becomes permanent, thereby producing a sustained increase in the monetary base leading to inflation. In Panama, the BNP finances the government, but the source of this financing is deposits in U.S. dollars at the bank rather than a printing press. Of course, continuing excessive fiscal deficits financed in this way through a state-owned commercial bank would ultimately jeopardize the solvency of the bank and require its recapitalization or funding with long term external debt.

Savings mobilization in Panama is carried out primarily through a well developed banking system that arose in large part from new legislation enacted in 1970 to modify the regulatory environment and allow for the development of offshore banking. From about twenty banks prior to this change, Panama was converted by the 1980s to a major international banking center with more than a hundred banks. There are currently two important state banks (the BNP and the Caja de Ahorro), 63 banks with general licenses (headquartered in Panama and conducting banking transactions both inside and outside the country), and 18 banks organized under foreign law but with licenses for operations in Panama.

After the recent crisis there were doubts whether Panama's banking system could recuperate. Nonetheless, when the restrictions that had been imposed on deposits, affecting the withdrawal of time deposits in particular, were lifted in 1990, there was a significant increase in both internal and external deposits, attesting to the basic health of the system. However, the impressive growth of the banking system and its ability to recuperate from a credibility crisis does not mean that Panama has the best financial system for mobilizing savings and channeling them to productive investments. The well developed national banking system provides financial services to domestic borrowers, but much of the development of offshore banking has not been complementary to the development of the domestic financial system in general or the securities market in particular.

One of the main conclusions that can be drawn from an analysis of Panama's banking system, and especially its growth and efficiency during most of the recent past, is that a well functioning securities market may not be crucial for supplying most financial services. The Panamanian Government and private sector enterprises already have, in general, good access to credit from the banking system at reasonable cost.

Off-shore lending has been well below the level of external deposits, so that Panamanian banks have substantial external liquid assets. Nonetheless, an important question is how much of domestic lending has been financed with external funds. This question is especially important because of the bad experience with such behavior in the countries of the Southern Cone. However, this has not been a major problem in Panama except during the 1987-89 crisis when the banking system relied heavily on foreign deposits for domestic lending. After the new Panamanian Government took office, the gap between domestic credit and domestic deposits closed quickly because of a huge inflow of Panamanian deposits and a flat demand for credit because of a lack of investment opportunities. As a result, liquidity indicators show that the banking system has become extremely liquid. Nonetheless, it is important to emphasize the potential danger: an off-shore financial center should not mix foreign and domestic funds because the volatility of deposits during a crisis that can put serious pressure on the banking system -- as happened in the recent crisis and could be repeated in the future.

Since the public sector is large compared to private sector, the allocation of domestic credit by the Panamanian banking system has been concentrated in the public sector. There appears to be a degree of segmentation among banking institutions in allocating credit to different economic sectors. While credit to the public sector is allocated mainly through stated owned banks, credit to the private sector is more likely to come from private foreign banks, and to a lesser extent from private Panamanian commercial banks and mortgage banks. Government owned banks do not appear to crowd out private banks in allocating credit to the private sector, except possibly in the case of housing. Private banks account for the majority of the credit market, but since the Banco Nacional Agropecuario (BNA) and the Banco Hipotecario do not take deposits, they are not included in the figures for the Panamanian banking system, so that the share of the state owned banks in the credit market may be significantly understated.

Reflecting the productive structure of Panama, private sector credit is mainly allocated to trade and housing construction activities -- the latter partly subsidized -- and to a lesser extent to industry, other types of construction and consumption. Credit to the agricultural sector is insignificant, largely reflecting risk aversion in view of the uncertain and variable returns as well as a lack of guaranties. Foreign banks concentrate mostly in financing trade, while Panamanian banks concentrate more in housing.

During the recent crisis not only was the number of banks reduced but also the number of agencies. In the case of banks with a general license -- the majority in Panama -- eleven closed while four new banks entered in the system. The number of agencies was reduced from 185 at the end of 1986 to 155 at the end of 1990. In the case of banks with an international license, four closed and one opened. As a result of this reduction, especially in the number of agencies, it has become more difficult for credit to be allocated to agricultural activities.

There are several important implications of the credit allocation patterns described above. The specialization of state owned banks in public sector lending is dangerous because it represents a large concentration of credit which could lead to severe problems if the Panamanian Government cannot pay its loans on time. The BNP does not make provisions for credit to the public sector, but such credit nonetheless implies a high degree of risk. After the crisis, when the United States Government reopened the accounts of the country, the BNP was able to increase its stock of international reserves substantially. However, that was a once and for all event which helped during 1990 but will not occur again in the future. To the extent that the fiscal deficit is not reduced, the sustained demand for credit by the public sector could threaten the future survival of the BNP.

The concentration of Panamanian commercial banks and mortgage banks in loans for housing construction has led to a dangerous mismatching in the term structure of funds. Loans of more than six months duration represent 68 percent of total loans of Panamanian commercial banks and 95 percent of total loans of mortgage banks, but their funds come from deposits that are mostly concentrated in shorter maturities. Deposits of less than six months represent 72.3 percent of total deposits of Panamanian commercial banks and 62.4 percent of total deposits of mortgage banks. Such term mismatching indicates a potentially risky situation that could put strong pressures on these institutions especially if, as happened in the recent past, there is a run on bank deposits. In addition, bank risk aversion against lending to the agricultural sector leaves an important portion of productive economic activity without reasonable access to credit, thus driving demand for credit to the BNA. However, the BNA is characterized by high arrears, with a substantial proportion of its portfolio either in default or rolled over, which seriously limits its lending capacity. As a result, agricultural activities receive little financial support from the banking system.

The Panamanian banking system operates in general very efficiently, especially in the case of foreign banks. Although there is little information directly available on spreads, they must be very low and similar to other international financial centers in order to be competitive. Reserve requirements, which act as an implicit tax on bank deposits and therefore translate into spreads, are low and similar to those in the United States, thereby allowing Panamanian banks to compete in the region by attracting deposits from various Latin American countries to lend abroad. The full integration of the capital account forces interest rates on deposits -- to which spreads are directly related -- to be at least as high as international rates. The Panamanian banking system adjusted significantly during the crisis by dealing with problem loans and by cutting costs through reducing the number of employees and agencies, thereby allowing lower spreads for future operations. Although Panamanian banks began to reopen some agencies in 1991, foreign banks have continued to operate with lower costs.

With respect to interest rate patterns in the banking system, several interesting points emerge. Interest rates on deposits have begun to decline in real as well as in nominal terms, probably as a result of increasing liquidity in the system and reconfirmation of the belief that Panama is fully committed to total capital mobility. Interest rates on loans, with the exception of commerce and housing, are somewhat lower at the BNP than at private banks. However, since the BNP lends heavily for housing at higher interest rates, lower rates for other activities are not likely to present a problem for its profitability. In addition, the BNP benefits from public sector deposits at zero marginal cost. Spreads at the private banks have not changed significantly as the majority of loans are allocated to commerce for which interest rates have been declining along with deposits rates. Nonetheless, given Panama's low inflation, lending rates continue to be high in real terms which may contribute to the low private sector demand for credit -- although uncertainty about policies to encourage the private sector, as well as questions of future stability, may be the primary reasons for this low demand.

Differences in interest rates on deposits between Panamanian banks and foreign banks of around two percentage points -- probably reflecting different perceptions of risk for the two kinds of institutions -- result in spread differentials in favor of foreign banks. Further reductions in spreads will depend mostly on how the Panamanian banks adjust to the shrinkage in the volume of resources in the banking system. Foreign banks have already made stronger efforts to adjust their infrastructure and operating costs during the crisis than Panamanian banks, thus giving the foreign banks a competitive advantage. Moreover, before the unfreezing of deposits in July 1990, many banks, especially the Panamanian ones, increased interest rates to try to keep their deposits. However, increases in interest rates on deposits could not be translated to increases in lending rates because of the danger of increasing the volume of non-performing loans. As a result, both the profits and spreads of Panamanian banks were reduced. However, to compensate for the increase in interest rates on deposits, some Panamanian banks began to allocate credit to consumption at higher rates.

Interest rates are subsidized for priority activities. Cross subsidies in favor of agriculture and housing and against consumption result from the reference rates set by the Comisión Bancaria. In the case of agriculture, the Comisión Bancaria sets a 13 percent reference rate, in addition to which producers receive a 4 percentage point subsidy. Similarly, interest rates for housing loans below $50,000 are subsidized with 4 percentage points, while those below $20,000 receive 5 percentage points, thus yielding interest rates of 9.25 percent and 8.25 percent respectively for the two classes of recipients (based on a reference rate for housing of 13.25 percent). These subsidies are financed through the Fondo de Compensación de Intereses (FECI) by a surcharge of 1 percentage point on consumption loans.

Subsidized credits do not have as important implications for the Panamanian financial system as they do for the financial systems in most other Latin American countries because the subsidies are not given through rediscounts and hence do not discourage saving mobilization and create pressures for additional monetary emission. In addition, subsidized credit for agriculture is insignificant, and subsidized credit for housing -- approximately 50 percent of total housing credit -- is not very important either.

Instruments for Monetary Policy and Capital Market Development

There is potentially a close link between the development of new instruments of monetary policy and the development of capital markets. In countries where central banks have been able to embark on programs of greater monetary stability and structural reform for the financial sector, they have not only removed certain impediments to the development of capital markets but they have also typically found it useful to initiate open market operations as the primary instrument to control liquidity in the financial sector. Open market operations are clearly superior to the traditional monetary instruments of reserve requirements (which are often excessively high in order to finance fiscal deficits) and rediscounts (which are usually associated with directed credit lines), and for capital market development they have the further advantage of requiring the trading of financial instruments for implementation.

<u>Costa Rica</u>

Structural adjustment in the financial sector has been aimed at reducing the costs of financial intermediation by increasing competition and consolidating the formal and informal financial markets. In addition, efforts have been made to improve the supervision of the financial sector. The main obstacles to achieving these objectives have been: (1) a highly interventionist Central Bank that has traditionally tried to apply its policies through piecemeal direct controls; (2) a highly inefficient commercial banking system in which the four state owned banks have had overwhelming importance; (3) an underdeveloped private financial sector consisting of banks and financieras; and (4) an underdeveloped supervisory body, the Auditoría General de Entidades Financieras (AGEF).

These issues forced the Central Bank to change both its aims and its instruments. With respect to aims, more emphasis was placed on economic stability and on the microeconomic management of financial intermediaries, while less was placed on promoting faster economic development and the expansion of production. With respect to instruments, the changes were also substantial.

Traditionally, the Central Bank had established general quantitative limits (límites generales de crédito) and specific quantitative restrictions (topes de cartera). Each year the Central Bank issued a credit program in which an overall credit limit and specific credit restrictions (as many as 50) were fixed for each bank. The commercial banks could neither lend more nor lend for other purposes. In addition, the Central Bank fixed the interest rate for each lending activity, as well as the rate of interest that commercial banks could pay to obtain funds from the public. The Central Bank also regulated the rediscount rate in ways to force the commercial banks to lend for certain specific activities and not for others. In short, the Central Bank was attempting to determine the quantity, price and allocation of all available credit. Moreover, the Central Bank also had to approve individually each of the new branches (sucursales) that commercial banks wanted to establish.

To achieve the new aims that emerged after 1982, these traditional instruments and policies largely had to be scrapped. Fragmented financial entities and activities had to be integrated into a single, unified financial system, and banks had to learn to operate as banks (make decisions and take risks). Major changes in controls over state owned commercial banks were initiated in the mid-1980s: (1) banks were allowed to lend amounts that they thought reasonable; (2) banks were allowed to decide to whom to lend (sectors, activities); (3) banks could decide how much to charge to their customers (interest rates plus other fees); and (4) banks could decide how much to pay for their funding.

The Central Bank progressively abandoned direct measures and began to rely more and more on indirect measures. The objective was no longer to determine amounts and allocation of credit but rather to influence overall liquidity. The Central Bank came to realize that the financial sector is, for practical purposes, a single entity. As a consequence, if the Central Bank tries to control the formal financial sector too much, then funds will be transferred to the informal financial sector, and Central Bank policy will become ineffective, if not totally useless.

With the main objective being to influence liquidity, open market operations became the most useful instrument. The Central Bank began by selling its own paper (Bonos de Estabilización Monetaria), and afterwards it also created an overnight market. In addition, the rate of interest rate for rediscounts was increased so that each time a commercial bank asks for funds from the Central Bank it would be unprofitable for the bank. Thus, rediscounts would only be used only to cope with liquidity problems and not to increase lending capacity. By trading its own paper, the Central Bank now influences the amount of liquidity and its price, the rate of interest.

The Central Bank has had to face certain major obstacles to put its new policies into effect. In addition to the public deficit, including the losses of the Central Bank, the main one has been the severe problems in the four state owned banks, in particular: (1) the state owned banks are extremely inefficient, and their high costs imply high margins and hence high costs for their customers; and (2) they have significant political influence, not only with various high Government officials but also with certain producer groups, so that they can sometimes neutralize or circumvent the policies of the Central Bank. In addition, there are weaknesses in the AGEF that presented serious obstacles if more freedom were to be given to the commercial banks, both state owned and private.

Because of these obstacles, new legislation had to be enacted in the mid-1980s that accomplished the following: (1) more autonomy was given to the Central Bank, as the number of ministers on the Central Bank's Board of Directors was reduced from three to one; (2) the AGEF was given enough power to intervene, and even close, financial institutions; (3) commercial banks could no longer accrue interest on loans more than 180 days overdue, which helped to "clean" bank financial statements, especially those of the state owned banks.

These financial sector reforms have not only provided instruments to be traded in Costa Rica's capital markets, but they have also begun the process of strengthening Costa Rica's financial intermediaries. It has sometimes been argued that the inefficiency of Costa Rica's state owned banks and the small size of its private banks has promoted the development of capital markets as a substitute for adequately functioning financial intermediaries. It might therefore be supposed that the aspects of financial sector reform that strengthen Costa Rica's financial intermediaries will hinder the continuing development of its capital markets. On the other hand, however, the services of financial intermediaries and capital markets may largely be complementary, as indicated by the importance of trading in instruments issued by both state owned and private banks. In any case, there are a number of other aspects of financial sector reform that may impinge specifically on capital markets.

In a monetary economy there is always a capital market in the sense that some economic agents have an excess of funds and other agents have a need for them, and many of these agents will somehow get in touch so that a transfer will take place at some rate of interest. Such transfers can take place in a formal capital market (a stock exchange, for instance) or in an informal capital market. From this point of view a capital market has been functioning in Costa Rica for many years. For example, the Government has sold its bonds to the public, and lawyers have often played an important role as moneylenders. From a more formal point of view, however, it was only after the creation of the Bolsa Nacional de Valores (BNV) that it could be said that a formal capital market exists in Costa Rica.

New legislation was enacted in 1990 to improve institutional aspects of the capital market by establishing the Comisión Nacional de Valores (the Costa Rican version of the U. S. Securities and Exchange Commission). One of the most important aspects of the new legislation is that it gives better protection to minority shareholders, and this should be a potential incentive for many savers to buy shares traded on the BNV. Nonetheless, it has to be recognized that the BNV is still a rather small and rudimentary institution, and three main characteristics are especially worth mentioning: (1) trading in shares is insignificant among transactions on the BNV, as shares do not represent even 1 percent of the total value of transactions, while bonds and certificates of deposits (CDP) account for almost 80 percent of all transactions; (2) private sector instruments are relatively unimportant, accounting for less than 20 percent of total transactions, while public sector instruments predominate; (3) a high proportion of all instruments traded are short term paper, and paper with a maturity of over 180 days is hardly traded at all. The main reason for this pattern is the lack of confidence of savers in the stability of the colon, so that inflation and devaluation are important obstacles to generating medium term savings in colones.

Among the main remaining issues that continue to impede the development of capital markets are: (1) the substantial "dollarization" of the economy; (2) the fact that many enterprises are still relatively closed family concerns that do not go to the capital market to get additional funds by selling shares but rather by selling short term commercial paper; and (3) the lack participation of large institutional investors (insurance companies, pension funds) in the purchase of shares, so that the demand of shares is also limited. The lack of participation by the

Caja Costarricense de Seguro Social (CCSS) and the Instituto Nacional de Seguros (INS) in capital markets is a particularly serious shortcoming since both these institutions typically run large surpluses and are conceptually ideal sources of longer term funds. Under prevailing law, however, these institutions are not permitted to invest in or lend to the private sector (except for certain special programs, such as housing finance, that are specifically authorized by law). Instead, the surpluses generated by these institutions are devoted to financing the public sector fiscal deficit.

Other factors, such as the tax system, also discourage the development of the capital market. Dividends are taxed twice (the company and the shareholders), while interest on debts is treated as a cost of production, so that companies prefer to have liabilities (loans) instead of increasing their own capital (shares). In addition, the cost of increasing capital is high for companies in terms of legal fees and stamp taxes. There is a lack of protection for minority shareholders in spite of the improvements in recent legislation. Lack of information is perhaps the most serious obstacle to expanding the capital market and, more specifically, the market for shares. To obtain adequate and reliable information on the companies is difficult. Sometimes no information is available, and when it is, the quality may not be good enough, so that it is difficult for potential investors to make decisions.

El Salvador

As in most Latin American countries, in El Salvador the instruments for the control of short-term liquidity have been rediscounts and especially reserve requirements. These two mechanisms are highly inefficient, both because they lack flexibility and because they interfere with optimal resource allocation. Moreover, under the current system of floating exchange rates, where the Central Bank of El Salvador is free to determine monetary aggregates, it seems timely to consider the desirability and the possibility of open market operations becoming the main tool for the conduct of monetary policy. In the past, reserve requirements have performed the double role of controlling liquidity and providing for the imposition of the inflation tax. Now there seems to be consensus that reserve requirements (which stand at 19 percent) should be uniform and decrease still further. In addition, the use of a single rediscount window for the sole purpose of the Central Bank performing its lender of last resort function, rather than for controlling liquidity, also seems to be compatible with the program of reforms for the financial system.

In terms of desirability, the flexibility and resource allocation neutrality of open market operations are powerful arguments. Open market operations could be initiated with the double purpose of conducting monetary policy and providing, during the process of interest rate liberalization, a reference rate according to which controlled bank rates would be set. In terms of possibilities, the two relevant questions are institutional capacity and the availability of instruments. Concerning the former, technical assistance would undoubtedly be required, but the initial impression is that most technicians at the Central Bank are receptive and enthusiastic and that the newly formed unit of Monetary Operations would be suited for the task.

If open market operations are to be the principal tool for short-term liquidity management and for longer term changes in the monetary base, both the existence and the quantity of proper instruments is a concern. Traditionally, in developed countries where open market operations have for many years been the tool of monetary intervention, those operations are performed by the sale and/or purchase of short-term government obligations such as treasury bills. There is no reason, however, why longer term instruments issued by the treasury or by the central bank could not be used.

As of June 1990, the following instruments were outstanding in El Salvador, issued by either the Central Bank or the Government -- Central Bank issues: (1) Bonos de Estabilización Financiera (BEF's) (19%) (436 million colones); (2) Bonos de Estabilización Financiera (BEF's) (10%) (590,000 colones). Government issues: (1) Bonos de Conversión y Consolidación de la Deuda Pública Interna Directa Serie "A" (14%), redeemable in 1999 (464 million colones); (2) Bonos de Conversión y Consolidación de la Deuda Pública Interna Directa Serie "B" (2, 4 and 6%), redeemable in 2019 (3,278 million colones); (3) Bonos Industria Azucarera Serie "B" (9%) (53 million colones); and (4) Bonos Industria Azucarera Serie "C" (9%) (6.1 million colones). With the exception of the second, which is in the hands of the Central Bank, all these instruments are in the hands of commercial banks, insurance companies and the public. In addition, there is a variety of instruments not issued by the Central Government but guaranteed by it, the most important of which are the Agrarian Reform Bonds at 6% interest, redeemable in 2019 (over 500 million colones, of which only 77 million colones are held by the Central Bank).

As in most other developing countries, an active informal capital market exists in El Salvador, and private brokers actively intermediate all the instruments listed above. Also, as in most other developing countries, private instruments are limited, mainly due to inadequacies in contract enforcement and lack of adequate prudential regulations concerning the activities of corporations. In the case of El Salvador, trade in shares is minimal and is likely to remain low even with the establishment of a formal market, as both supply and demand are restricted (supply, because of the family structure of many corporations; and demand, because of the lack of effective oversight of corporations making public offerings of shares). In the case of bonds, demand is also restricted due to the costs of enforcing contracts. A recent counter-example is the rapid development of an active market in short-term promissory notes (up to 90 days) of large corporations, for which low enforcement cost seems to be the important factor.

There is an active movement in El Salvador for the establishment of a Bolsa de Valores (and one in fact existed between 1965 and 1974 but disappeared because of a low volume of transactions). Legislation has been drafted, and tax treatment is under review at the Central Bank. A natural question, in light of the considerations mentioned in the previous paragraph, is whether the effort should be supported. The answer would seem to be in the affirmative considering the overall reforms of the financial sector, including interest rates, that should eliminate some of the obstacles for a more active mobilization of resources. The volume of shares and private paper transacted could be expected to be small for some time, but the active informal market in instruments of the public sector could quickly be transferred to a more transparent market.

Panama

There are few savings instruments at the disposal of the public in Panama. The usual ways that people hold their wealth in Panama are dollar deposits in the banking system, housing, and, to a limited extent, bonds and shares of private corporations and government bonds. The Panamanian securities market is incipient and characterized by a small regulated market concentrated mainly in government paper and a few private sector instruments. As in many other Latin American countries, a parallel informal market exists for private documents, the magnitude of which is difficult to know. The informal market exists primarily because the fiscal treatment of capital gains on savings instruments has discouraged the use of the regulated market. More recently, and especially during the crisis when banks were closed by the Panamanian Government, liquidity needs for transactions contributed greatly to the development of the informal market and to the creation of the Bolsa de Valores of Panama.

According to many observers, the efficiency of the banking system has contributed to the small and underdeveloped nature of the securities market, as creditworthy private corporations have good access to credit on attractive terms making it unnecessary to resort to the securities market for funds. Bank credit is the cheapest source of financing, and even long term loans -- although officially nonexistent except for housing -- can be obtained indirectly through the continuing rollover of short term loans. The fact that the Bolsa de Valores was created and developed during the banking closure, and that it came to a standstill after the banking system reinitiate its operations in 1990, are additional indications confirming this conjecture.

The securities market is organized around official agents (corredores), but there are also informal agents. The recently created Bolsa de Valores is supervised by the Comisión Nacional de Valores (CNV) which is a part of the Ministerio de Comercio e Industria. The CNV had already been created in 1970 to prevent frauds involving mutual funds. The CNV supervises private corporations that offer bonds or shares in the official market -- these must be registered at the CNV and provide information openly -- and the CNV is also the only entity authorized to give licenses to official agents. The profits tax on capital gains can be avoided for firms that have only a few owners of shares by voluntarily registering at the CNV with the Registro Voluntario. In the case of firms offering shares or bonds publicly, however, it is a requirement to be registered with the Registro Oferta Pública. As of early 1991, there were 125 firms registered, 71 of them with the Registro Oferta Pública.

The total value of securities in circulation reveals the small size of the securities market compared to the amount of deposits in the banking system. It is also interesting to note the wide range of implicit interest rates on government papers and that these rates do not put upward pressure on the level of interest rate in Panama. Government papers account for 20 percent of the total value in circulation and include a wide range of different categories of financial instruments. Long term government bonds have maturities between five and ten years and different nominal interest rates. The quotations for all of these are similar and reflect a low demand as a result of the default on debt service payments by the Panamanian Government. For example, bonds that matured in 1988 were not honored and interest payments were also postponed. Implicit interest rates are thus quite high on government bonds -- around 50 percent per year -- as these bonds are mainly demanded to be used as collateral.

Treasury Bills are held by banks as they can be used to fulfill reserve requirements so they are not quoted on the Bolsa. The Panamanian Government is servicing the interest payments. MOP promissory notes with four years maturity have recently been issued, but they were not accepted in the market because of the general default of the Panamanian Government in debt service payments. Only two million out of ten were placed. Social Security promissory notes with fourteen months maturity and zero interest rates have implicit rates ranging from 5.3 percent for three months to 8.7 percent for twelve months. Certificados de Abono Tributario (CAT) serve as payment instruments, and their implicit interest rates range from 1.5 percent for one month maturity to 39 percent for twenty months maturity. Certificados de Poder Cancelatorio (CPC) correspond to tax reimbursements, and their implicit interest rate is 1.6 percent for a one month maturity. Creditos Fiscales correspond to interest subsidy reimbursements, and their implicit interest rate is 1.5 percent for a one month maturity.

Among private debt instruments, CEDIs and corporate bonds are the most common. CEDIs correspond to certificates of deposits frozen in the banking system that were issued during the crisis. Quotations vary according to nominal interest rates and maturities, and the implied rates range between 10 and 20 percent for private banks. There are no significant differences in implicit rates among private banks or between private banks and the BNP. Corporate bonds have implicit rates of return of around 12 percent. Corporate bonds are accepted in general but the degree depends on the company's prestige and the transparency in the subscription mechanism. In terms of total amounts in circulation, shares are the most important instruments. However, equities are mainly held by small numbers of families or groups, and only about one third are traded in the market -- and even of these, a large portion is held by a small number of persons. Most shares have very low quotations relative to book value, and few corporations are willing to disclose information to fulfill the requirements imposed by the CNV. Of the small number of firms that are registered at the CNV, approximately thirty are traded on the Bolsa.

Taxation of Financial Markets

In many countries the tax system retards or distorts the development of capital markets through differential taxation of certain types of financial instruments. The most common examples involve different treatment of dividends and interest with respect to their taxation as income and their deductibility as expenses, and additional complications can arise in countries with significant inflation.

Costa Rica

In Costa Rica, interest payments on bonds, certificates of deposits, etc. are subject to a tax of 8 percent that has to be withheld by the entity making the interest payment. This represents an effective reduction in the rate of interest. On dividends distributed by corporations there is a tax of 5 percent that has to be withheld by the corporation. Also, the fact that the Central Bank does not pay interest on the compulsory reserve requirements of commercial banks makes reserve requirements equivalent to an implicit tax on banks and consequently leads to an increase in the cost of financial intermediation.

In general, the present tax system provides incentives for companies to become more indebted (obtain more loans) rather than increasing their capital. There is double taxation of dividends, while in the case of loans there is a potential profit as the real value of principal and interest payments falls with inflation. In addition, an increase in capital implies further costs of 1 to 2 percent of the amount of the increase.

The present tax system has two other shortcomings: it subsidizes certain types of profits, and it imposes an extra tax on certain types of losses. Corporations do not have to pay a tax on the gains they obtain from the reduction in the real value of their liabilities (loans) due to inflation, in spite of the fact that this reduction in the real value of loans implies a net profit. On the other hand, those corporations having assets in the form of outstanding loans do not receive any tax benefits even though such assets have lost real value due to inflation. A similar distortion is present with interest income and payments. Corporations receiving interest have to pay income tax on the nominal value of the amount received, while corporations obtaining the benefits of the reduction in the real rate of interest due to inflation can still deduct the full nominal value of interest payments as a cost.

In view of this situation certain changes in tax legislation would be appropriate: (1) income tax should be paid not on nominal interest income, but on real interest income; (2) the amount of nominal interest paid should not be deductible from taxable income, only the amount of real interest; (3) for depreciation purposes, the nominal value of the assets should be increased in line with the price index; and (4) the double taxation of dividends should be eliminated, so that either the corporation or the shareholder should pay, but not both. These changes would make the tax system more neutral and thereby tend to foster the development of Costa Rica's capital markets.

El Salvador

The main characteristics of the tax system in El Salvador relevant to financial markets can be summarized as follows. There is, as in many countries, a double taxation of dividends, as they are subject to both the corporation and the personal income tax. Tax rates on corporations are progressive, with marginal rates of 10, 20 and 30 percent. The personal income tax has marginal rates ranging from 10 percent to as high as 50 percent for taxable income over 250,000 colones (about US$31,500). Corporations and individuals are also subject to a tax on net worth with rates of .5 and 2 per cent.

Exempt from the net worth tax are deposits in national credit institutions, Agrarian Reform bonds, other bonds issued or guaranteed by Government and shares. Exempt from income taxes are interest on instruments issued or guaranteed by the public sector, bank deposits, foreign assets and mortgage bonds. Instruments issued or guaranteed by the public sector are also exempt, with minor variations, from inheritance taxes, the net worth tax and stamp taxes. In some cases it is even stated that they are "exempt from any current tax or any tax to be established in the future." In addition, in many cases their coupons for due interest are accepted at face value for taxes. Operations at commercial banks are also exempt from stamp taxes.

A proposal is under consideration at the Central Bank to grant the similar exemptions to instruments properly registered and negotiated through the Bolsa de Valores. Two main observations can be made concerning this proposal. The first is whether more exemptions should be granted rather than working toward more uniform treatment. In this case, the answer depends on a second-best argument, i.e., that the preexistence of exemptions for the banking system justifies the granting of exemptions in a sector that can be seen as a close substitute. The outcome of the proposal is likely to be the granting of exemptions so long as exemptions for banking instruments are not eliminated. The second observation is the danger of fictitious registrations at the Bolsa de Valores that might ultimately involve the bulk of transactions.

Panama

One surprising fact regarding Panama is the sharp contrast between a well developed banking system and an incipient securities market. One explanation may be that the ownership of private enterprises is predominantly in the hands of closed family groups or association of individuals who are not interested in having more broadly based ownership. This may in part be the consequence of two main factors: (1) the presumption that family and friendship are necessary for faithfulness; and (2) that procedures for tax evasion and black market operations require small groups of individuals.

Another explanation, perhaps equally important, is that Panama's tax system discriminates against the development of a securities market. Panama's tax system needs an overall reform to improve its impact on resource allocation and equity. Taxes are in particular discriminatory against a securities market and in favor of interest from bank deposits and government bonds that are tax free. Among the non-neutral aspects of the tax system that are important for the development of securities markets are: (1) a personal income tax with a 10 percent withholding tax on dividends and a range of 2.5 percent to 56 percent on other types of income; and (2) a corporate income tax that ranges from 20 percent to 50 percent. A number of aspects of the tax system are biased specifically against bonds and especially against equities (and in favor of deposits in the banking system) and thereby undermine the development of a securities market: (1) interest on bank deposits and government bonds are exempt from taxes; (2) short term bonds (less than three years maturity) are taxed at 5 percent on interest payments, with the remaining 95 percent not accrued to taxable income; and (3) dividends are taxed at 10 percent with the remaining 90 percent not accrued to taxable income. In addition, 40 percent of undistributed profits are taxed at 10 percent, and capital gains accrue to taxable income.

Tax collections on dividends were high during the 1985-87 period but became negligible by 1990, so that there would not be a significant reduction in fiscal revenues if the dividend tax were eliminated. In fact, the CNV is proposing legislation to exempt dividends on ordinary shares (or preferred shares convertible to ordinary shares) with rights of voice and vote from income tax. The alternative of taxing interest income from bank deposits would not be advisable because of implications for the international competitiveness of Panamanian banks. Nonetheless, it does not appear that asymmetric tax treatment is the main factor limiting the development of securities markets -- rather disclosure of information and openness to outsiders are the main restrictions to future securities market development.

Concluding Comments and Major Recommendations

In the case of the Costa Rican macro-financial situation, considerable progress has been made since 1980-1982, as inflation, exchange rate fluctuations, and the fiscal deficit have all been brought under better control. Nonetheless, weaknesses remain, especially because of the difficulty of imposing fiscal and monetary discipline in a highly politicized economy such as Costa Rica's. Although substantial progress has also been made toward the reforming the Costa Rican financial sector, much remains to be done to increase efficiency and competition in financial markets, to reduce the costs of intermediation, and to offer more and better services to customers. Among these tasks are to eliminate the unnecessary powers of the Central Bank and to increase the capabilities of the AGEF.

Two obstacles remain in particular. First, the public sector is much too large, so that crowding out of the private sector is unavoidable, and this is not just a question of how to finance the public deficit. Even if the deficit is financed in a "sound" way (e.g., through taxes), the amount of resources that the private sector has to transfer to the public sector (either through taxes or buying government bonds) is simply too large, so that not enough resources remain to allow for rapid growth in the private sector. Second, the state owned banks still enjoy a monopoly of sight deposits and continue to have a predominant influence on the financial sector as they are by far the largest credit institutions in the country. Thus, there is no way to improve the financial system significantly without taking the necessary measures to deal with the state owned banks. Their obvious lack of efficiency and poor performance means that they have to operate with large spreads just to cover their high costs, which increases intermediation costs throughout the financial system. The growth and profitability of the private banks and the securities exchange are in part due to the inefficiencies of the stae owned banks, but this is clearly not the most appropriate way to promote their development, which in turn is limited by the excessive size of the public sector.

Major modifications of the foreign exchange regime are also important, including allowing transactions in foreign currencies. To open the capital account of the balance of payments, now that the opening of the trade account is well underway, would help the "dollarization" of Costa Rican financial markets in the favorable sense (i.e., the local currency, the colon, would have to compete with other currencies) which would create new opportunities for capital market development. Allowing transactions in foreign currencies would allow Costa Rican entities to issue paper denominated in foreign currencies as well as forcing greater stability of the colon. In addition, it is important to reduce inflation further in order to increase confidence in the colon, so that a medium term market for financial paper in local currency can also be developed.

Although Panama is recovering well from its recent crisis, problems remain, and these problems cannot be attributed exclusively to the crisis. In fact, there are more fundamental problems that have their origins in several decades of a misguided approach to economic development. In particular, there appears to be government intervention throughout the economy based on an ideological persuasion that the private sector cannot provide either an efficient allocation of resources or a reasonable distribution of income. This, in turn, is reflected in large public utility companies (e.g., providing energy, transportation and communications) which usually account for a major proportion of activity in equities markets but do not participate in the Panamanian market because they are state owned. This, in turn, contributes to the lack of a well organized securities market able to mobilize savings and channel them to productive investments or to assimilate the trading of a significant volume of securities.

Nonetheless, some fundamental changes in public opinion seem to be taking place, so that prospects for the development of a securities market in Panama may be improving. Although Panama currently lacks an active securities market, the banking sector has developed steadily with efficiency and sophistication. Moreover, Panama is second to none in Latin America in its integration into world financial markets. The secret to this success has been very simple: Panama is favored with a strategic geographical location for trade and finance and has been able to maintain a stable currency system based on the U. S. dollar. Panama's private sector is well aware of the poorly developed securities market, and some specific interest exists because it is owned by a broad consortium of banks and other investors including eight brokerage houses. In fact, the Panamanian Chamber of Commerce has a project with the Chicago Mercantile Exchange based on the assumption that Panama has the potential to become a more important financial and investment center for Latin America. These two institutions are currently providing assistance to develop a regulatory infrastructure that can enhance investors' confidence. The basic idea is that an optimal structure involves a self-regulatory entity that provides primary enforcement, supplemented by a government structure that functions when primary enforcement proves inadequate.

A major attraction of the Bolsa project is that it is oriented toward international markets where Panama has been shown to possess significant comparative advantage. The Bolsa also has the attraction of being thought of as a private entity primarily for trading private securities. This contrasts sharply with projects in many other countries that are thought of primarily as ways of developing a market for domestic government debt. Considering the inflationary performance of countries having a wide array of public instruments to carry out monetary policy leads to the conclusion that there is no clear advantage from having a large number of instruments that may induce the government to borrow heavily in domestic financial markets. In many countries, government debt is a major source of inflation as the government eventually has to rely on monetary emission to pay the interest on such debt. This does not mean that a securities market is unimportant, but rather that the impetus for its development should come as much from private securities as from government debt.

Prospects for developing a securities market in Panama may also be enhanced by success in implementing the Government's privatization program and by an increase in the demand for long term funds as a result of the banking system's current conservative lending policies. The new Government's approach to economic development is based on the view that Panama's future economic growth will be generated largely by the private sector, in parallel with a trend in public opinion in favor of privatization after the marked failure of several decades of public sector dominance of various economic activities. Privatization is currently being considered for several public enterprises in agriculture, insurance, transportation, tourism and trading. In addition, the Government is considering the payment of arrears to domestic suppliers (the floating debt) of about US$ 160 million by issuing promissory notes of different maturities. Furthermore, Panama's foreign debt could be reduced through a voluntary debt equity swap mechanism, for which a securities market would be essential. There may also be prospects for increased demand for instruments that might be traded on a Panamanian securities market. For example, insurance companies can hold their technical reserves either in government or private bonds. The Social Security System, although in poor financial condition after the recent crisis (partly because the government stopped paying its obligations), might become healthy and thus be an important provider of long term funds to the securities market, as happens in many other countries.

The potential for developing a securities market will also depend on several macro-financial and institutional issues. There are currently few good opportunities for investment in physical capital in Panama, and the demand for long term funds will first require the demand for investment to recover. Until the macroeconomic environment and the system of incentives for growth are changed through structural reforms that stimulate production of tradeables as well as reducing the size of the public sector, it seems unlikely that the securities market can become more developed. In addition, the efficiency of the banking system reduces the need to resort to the securities market for funds. Moreover, as insider lending is allowed in Panama, large firms and economic groups have an easy and cheap way to finance their investments by creating their own banks. Future regulations that limit insider lending to related groups may be an indirect way to contribute to the development of the securities market.

The Government's failure to make payments on bonds and to service foreign debt is a severe limitation for any future government bond market. Uncertainties about future payments make government bonds undesirable, as reflected in the low quotations noted above. It is surprising that the Panamanian Government seems to give such a low priority to this issue. The small number of firms that have fulfilled the CNV's conditions for public offerings also impedes the development of the securities market. The unwillingness of important economic and family groups to open their companies to outside investors and to disclose information to the general public is perhaps the most severe restriction to developing a securities market. As an example of how closed Panamanian corporations are, it can be noted that the CNV authorized the issuance of US$ 61.5 millions in equities during 1990, but only US$ 2.4 was transacted on the Bolsa. This means that the remaining authorized capital was transacted among groups and families that register their firms voluntarily at the CNV to avoid taxes.

Although El Salvador has progressed less than Costa Rica and even than Panama in developing a formal securities market, it may in fact have the best prospects for rapid development. In terms of the macroeconomic environment, El Salvador has achieved greater fiscal stability than either Costa Rica or Panama and has at least as open a trade and foreign exchange regime. El Salvador is also in the process of strengthening its Central Bank and its Superintendency, both of which are essential for the development of financial markets and institutions in general and may also contribute to securities markets in particular. The current programs to recapitalize and privatize El Salvador's state owned financial institutions may either retard or accelerate the development of a formal securities market depending on two factors: (1) the success of the programs; and (2) whether, in the case of El Salvador, banks and other financial institutions turn out to be complements or substitutes for formal securities markets. In any event, El Salvador, like Costa Rica and Panama, will face major barriers to the development of trading in private sector securities based on difficulties with respect to the disclosure of information and the protection of minority interests -- issues which may have far more importance than the macro-financial environment for the development of formal securities markets in almost any country.

ABSTRACT

Key Macro-Financial Elements in the Development of Central American Capital Markets: Lessons from Costa Rica, El Salvador and Panama

by

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This summary report draws upon separate reports that describe macro-financial conditions in Costa Rica, El Salvador and Panama and how these conditions impact on the development of capital markets in each country. This report highlights the similarities and differences among the three countries that appear to have particular relevance for the development of capital markets in the Central American region.

The report summarizes the following macro-financial conditions for each of the three countries:

- the fiscal situation, including not only the central government but also the Central Bank and autonomous government agencies, as well as the financing of the deficit;

- changes in the foreign exchange regime and, briefly, the behavior of the exchange rate and the balance of payments;

- the behavior of monetary aggregates, inflation and interest rates, as well as changes in government monetary, credit and interest rate policies;

- instruments for carrying out monetary policy and for the further development of capital markets; and

- the effects of taxation on financial markets and instrument.

Key findings are that:

- Costa Rica has by far the most developed securities market in the region, even though its financial reform efforts have been continually impeded by large fiscal deficits, a large external debt, and a financial system dominated by highly inefficient public-sector banks;

- Panama's formal securities market is largely inactive despite its highly efficient banking system dominated by the private sector together with a reliance on the U.S. dollar for its currency; and

- El Salvador has no formal securities market, having passed through internal political instability during which banks and many other major private-sector enterprises were nationalized. Yet recent liberalization efforts suggest this genuine "change in regimes" could lay the basis for the rapid development of a significant securities market.

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