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FINANCIAL MARKETS IN LATIN AMERICA AND THE CARIBBEAN

A Report Prepared for

U S Agency for International Development
Bureau for Latin America and the Caribbean
Office of Regional Sustainable Development
Broadly-Based Economic Growth

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We are thankful to these friends Needless to say, any errors of the Report should not be attributed to them We are solely responsible for the contents of this Report

FOREWORD

The Plan of Action of the 1994 Summit of the Americas underscored the need to develop Latin America's financial markets to help " ..reduce the cost of capital by enhancing depositor and investor confidence". Responding to this call to action, and to further its goal of promoting broad-based economic development in the Hemisphere, USAID's Bureau for Latin America and the Caribbean commissioned the preparation of this background Report on financial policy in the region. The Report serves as an important input for the design and implementation of the Bureau's Hemispheric Free Trade Expansion Project.

This Report identifies and summarizes the key constraints that block the development of financial markets in the Hemisphere. It consists of three chapters Chapter One portrays an overview of how far the region has advanced in reforming its financial markets. It also highlights key problems that still constrain the development of financial markets which, in fact, are common to the entire region. The second chapter is descriptive. It details the fundamental characteristics of the overall financial policy, banking sector and capital markets in each country. For convenience, the countries are grouped regionally: Central America, the Andean countries, Mercosur, and the Caribbean The third and final chapter provides recommendations for prioritizing USAID assistance in the development of financial markets in the Hemisphere.

In essence, this Report should be taken as a first cut analysis of the status of financial reform and of the primary constraints that hinder the expansion of financial markets in Latin America and the Caribbean. It was prepared in a three-month period in the Spring/Summer of 1995, relying heavily on a review of the literature and on interviews with experts from Washington-based multilateral financial entities, academia, and private banks. These interviews were facilitated with the preparation of a questionnaire that was submitted in advance. This questionnaire is incorporated in the Annex of this Report.

EXECUTIVE SUMMARY

1. The crisis of the 1980s brought into sharp reality the sorrowful state of the financial markets of Latin American and the Caribbean. With the cooperation of multilateral donors, governments set about designing and implementing a major overhaul of financial systems. Well into the 1990s, there is no doubt that the scope of reform has been impressive. Nevertheless, as long as severe institutional and economic constraints are not properly addressed, it will not be not possible to ascertain with certainty that the reform is conducive to establishing the foundations of solid financial markets which can add to and facilitate the task of economic development in the Hemisphere.

2. The region is economically fragile because of its vulnerability to external shocks. Persistently adverse terms of trade have been a historical constant, and they bear significance for financial markets through the impact they exert on the fiscal accounts. When fiscal deficits rise rapidly as a result of a severe deterioration of the terms of trade, government authorities in Latin America and the Caribbean have traditionally resorted to dispensing implicit or explicit taxation on financial intermediation as a way of buffering this shock.

The vulnerability of the region to external shocks is nowhere more vividly demonstrated than in the dependence on foreign capital In fact, another historical constant of the region is over-borrowing in international financial markets, followed by severe economic trauma when foreign loans dry up or when the flow of funds turns negative. In recent times, this has been painfully revealed with the emergence of two major foreign debt crises (in 1982 and 1994) This vulnerability can take a dramatic turn when countries opt to embrace an all-out opening of their capital accounts Severe overvaluation of domestic currencies usually follows periods of short-term capital inflows and this poses serious dangers for the stability of banks when drastic balance-of-payments adjustment becomes inevitable.

3 In the past, Latin American and Caribbean countries have applied development strategies that contributed to the marginalization of vast parts of their populations. The consistent application of policies of exclusion ultimately resulted in the emergence and strengthening of so-called dual economies This dual economic structure underscores an uneven income distribution and affects the development of financial markets in at least two ways. First, it underlines an acute segmentation of markets which ultimately

prohibits the advantages that result from specialization and economies of scale. Second, an uneven income distribution aggravates social and economic instability. A vicious circle ensues since the more socially and economically unstable the country, the more prone are wealthy groups to diversify their investments, which includes capital flight, without a doubt one of the major impediments for the development of Latin American economies.

4 The region is characterized by high cost of capital, which is largely explained by the large intermediation margins that permeate the banking sector. This is a serious problem that endangers free trade policies because firms find that high financing costs undermine their competitive position *vis-a-vis* foreign rivals This problem is very serious in Latin America and the Caribbean, as evidenced in several countries in which some local firms have found it cheaper and more convenient to seek financing from foreign lenders This option, naturally, has not been available for the vast majority of local firms whose only alternatives have been to either absorb the finance costs or simply shelve any investment plans.

5. The development of financial markets in the region is impeded by faulty government intervention. The presence of state banks is a case in point. At present, and considerable as they still may be in some countries, the principal problem does not primarily lie with the losses that these entities incur. Far more important is the fact that in most countries, the state banks are sources of important distortions, as they price their products capriciously and are not subject to the reserve requirements that are applied to the private banks Misguided state intervention is also manifested in the enactment of high reserve requirements which, naturally, are closely associated with the overall macroeconomic fragility that the region endures Whether they serve the purpose of financing fiscal deficits, of funding central banks' rediscount credit lines, or stemming a flight to other currencies, high reserve requirements contribute to the segmentation of financial markets This is evidenced by the emergence of parallel or informal markets where these restrictions do not apply and where a vast number of financial transactions are carried out.

6. Inefficient legal and judiciary systems constitute perhaps one of the major constraints for the development of financial markets. In several Latin American countries the rights of lenders are not properly protected In general, the law implicitly favors borrowers because actions to exercise guarantees in the event of loan defaults are often tedious and costly. Another problem is that legal and regulatory frameworks in several countries do not protect customers because they do not obligate banks to disclose

relevant information to the public. Last, but not least, there is lack of enforcement of prudential norms and regulations, including capital adequacy ratios and the provision of reserves against loans of doubtful recovery

7. As significant as the losses from the Savings and Loan fiasco in the United States were, under no circumstances can they be compared, in relative terms, with the major financial debacles that some Latin American countries have had to shoulder. Financial crises occur in the region because of the the tendency for banks to undertake risky behavior, expressed in substantially above-market rates on deposits to cover liquidity needs, and also by decisions to offer loans to risky borrowers at above-market interest rates. The reason banks undertake this risky behavior is that there are incentives for them to do so. These incentives are basically expressed in the presence of three conditions: undercapitalization of banks, implicit deposit insurance, and lack of adequate supervision of financial entities.

8 While supervisory agencies in several countries have sustained major reforms or are currently in the process of improvement, focus must be placed on three important changes. The first is to shift from a traditional auditor's approach to supervision toward one which embraces the complexities inherent in today's financial markets. The banking industry has sustained a radical transformation in the last twenty years, the result of a generalized process of deregulation, globalization, faster communication and product innovation. The traditional auditor's approach, which relies on financial ratio analysis and examination of financial statements, is thoroughly inadequate Today, supervisors must be well versed in banking techniques as well The second improvement in supervision recognizes that a system that provides early warning signals would be of immense value in a region in which supervision has historically been *ex post*. Indeed, colossal bank failures in large and small countries alike could have been prevented if supervisory agencies had adopted more efficient systems to detect bank mismanagement Finally, permanent training programs to upgrade skills and better pay are necessary requirements for effective financial supervision.

9. Governments should intervene in financial markets only when they have the capacity to do so effectively and when there is reasonable certainty that social returns will outweigh the costs of intervention. One area that needs particular attention relates to the opening of the capital account. After the long pursuit of restrictive policies, many Latin American countries, since the late 1980s, reversed direction and embraced external liberalization, purportedly to attract capital inflows. They largely succeeded in doing so, but the nature of the inflows were generally short-term. In the largest

countries, stock markets flourished, yet little attention was given to the fact that the resulting currency overvaluation established a serious conflict between the goals of foreign investors and those of long-term development

10 In the Central American region, the reform process of capital markets is far from completed The major constraint relates to the fragile macroeconomic situation in these countries. Costa Rica must bring its large fiscal deficit under control, whereas the economies of Honduras and Nicaragua are crucially dependent on help from foreign donors Guatemala and El Salvador seem to be recovering, but the decision to adopt the dollar as legal tender in El Salvador, probably starting in mid-1996, raises concerns. While this decision will probably boost its capital markets, it offers no guarantees that faster economic development will follow.

By far, El Salvador exhibits the most advanced banking sector of the region, with the lowest intermediation margins. In Costa Rica, Honduras, Nicaragua, and Guatemala spreads still remain very high. State banks largely dominate the banking sector in Nicaragua and, to a lesser extent, in Costa Rica. These entities are thoroughly inefficient and the source of important distortions. In Nicaragua, the state banks have preferential access to rediscount lines from the Central Bank, while in Costa Rica, the private commercial banks benefit handsomely from their inefficiencies. Yet, these countries have no plans for their liquidation or privatization.

High reserve requirements in Honduras, Costa Rica and Guatemala explain the acute market segmentation that characterizes the banking sector in these countries. A proliferation of informal financial entities (*financieras*) and offshore bank subsidiaries that escape regulation and supervision are the logical outgrowth. These entities mobilize substantial resources. On the other hand, banking in the entire region is highly concentrated in urban areas and in selected economic activities. Concentration also applies to the beneficiaries of credit. In this regard, substantial volumes of so-called *préstamos relacionados* permeate banking operations in Honduras and Guatemala. Though these operations probably face more efficient restrictions in the rest of the countries, it is not uncommon for banks' owners in the entire region to have interlocking businesses with other financial entities and even sometimes with non-financial concerns Consequently, inside lending escapes detection This fact dramatizes the urgency for adequate prudential norms and efficient bank supervision. To a high or low degree, all countries need to improve their bank supervisory systems

Capital markets in Central America are poorly developed. The main instrument that is traded is government debt Trading of corporate equity is almost unheard of due to the unwillingness of firms, mostly family-owned, to go public.

11. Financial markets in the Andean region feature sharp contrasts Venezuela, one of the largest economies in the Hemisphere, is enduring its most severe crisis in decades. The fiscal deficit is too high and inflation is repressed by subsidies and price controls of doubtful efficacy. These measures are not conducive to rapid recovery. The unstable economic and political situation threatens to unravel another banking collapse Colombia, in sharp contrast to Venezuela, has enjoyed economic stability since at least the 1960s This country has been blessed by consistent application of sound fiscal policies but still faces the problems of how to keep inflation under control and how to contain the tendency for currency overvaluation Peru has engineered a remarkable turnaround but, like Colombia, it suffers from severe currency overvaluation The greatest challenge in this country is to maintain fiscal discipline in the upcoming years, especially when the revenues from privatization of state companies cease The macroeconomic situation in Ecuador is slowly improving, but in Bolivia, the poorest country of the region and the most dependent on foreign donors, it will take years to achieve sustained economic development.

Colombia, Bolivia and Peru have made great strides with respect to the privatization of state banks. Ecuador is moving very slowly, if at all, in this regard, whereas the sell-off of banks is unthinkable in Venezuela at this time High intermediation margins characterize banking operations in this region. These are bound to be reduced in Peru, Ecuador and Colombia, where new entrants will hopefully introduce more competition. In Bolivia, where half of the banks are probably insolvent, the government has yet to recognize this issue

In general, the average maturities of both loans and deposits are short term in the entire region, and these services are, in practice, denied to the vast marginalized clientele of Peru, Bolivia and Ecuador. Regarding supervision, all countries need some degree of technical assistance. In Venezuela, a major overhaul of the supervisory agency is a matter of utmost urgency.

The regulatory frameworks that govern capital markets have been modernized only in Ecuador, Colombia and Peru, but enforcement of regulations that protect investors is problematic, especially in Peru. Trading of all financial instruments is expected to keep growing in Colombia and probably less rapidly in Peru, where the market is dominated by foreign participants. In Venezuela, the market suffered a debacle because the collapsed banks were active players in it and no recovery is in sight. Finally, very slow growth is expected in Ecuador and Bolivia, since their economies are still small and characterized by heavy concentration of incomes.

12 The Mercosur countries concentrate the largest and most dynamic economies of the Hemisphere outside NAFTA. For several consecutive years, Chile[a] has posted strong economic performances and this has clearly benefited its banking industry and its capital markets One of the cornerstones of this success has been a pragmatic monetary policy that has prevented a real appreciation of the peso. The country also boasts the highest savings ratio of the Hemisphere. These two factors account for the relative ease with which the country managed the crisis unleashed by the collapse of the Mexican peso. Overall, the banking sector seems to be profitable and has high quality assets. In recent years, the expansion of its capital markets has been impressive In this regard, the introduction of private pension funds has played a big role through investments in bonds and corporate equity.

Argentina, unfortunately, faces economic recession ahead, and this is bound to negatively affect its banking sector. The authorities are wedded to the rules of the Convertibility Plan which has clearly benefited the economy, but which may not survive if a severe bank liquidity or solvency crisis forces the Central Bank to bail-out the banking system. Even before the crisis, the banking sector was highly inefficient, characterized by large intermediation margins, high concentration and poor quality of portfolios. The system should contract in the near future with the privatization or liquidation of provincial banks and with mergers or liquidation of a large number of small private commercial banks. The capital market remains undeveloped, a vehicle for speculation more than for raising capital.

Brazil will continue to wrestle with the obstacles that have impeded a thorough public sector reform and that explain the high inflation rates posted for so long At time of this writing, the outcome remains uncertain. The fact that very little progress has been made with respect to the restructuring and/or privatization/liquidation of state banks does not bode well for the future. Private commercial banks resemble Chile's more than Argentina's. they are dynamic and modern, and yet poorly supervised. The country also boasts the largest stock market of the Hemisphere outside the United States, but

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[a]This country is not a formal member of Mercosur. It is included in this category for reasons of convenience

trading is heavily concentrated in government securities. This deprives many small and medium sized firms of liquidity. In addition, high corporate taxation fuels tax evasion in this country. This is a factor that makes firms wary of going public, for then they would be forced to release accurate financial information.

Economic conditions in Argentina and Brazil largely determine the dynamism of the economy and of the banking sector in Paraguay and Uruguay. Banks in Paraguay are owned by powerful economic groups of the country, whereas in Uruguay, foreign-owned banks, which operate under a framework of offshore banking, predominate Lack of effective supervision is a big problem in Paraguay, while the main constraint in Uruguay lies in the distortions that are transmitted by inefficient state banks. As regards stock markets in these countries, they are very small and for all practical purposes undeveloped.

13. Not unlike the Central American region, the expansion of financial markets in the Caribbean is constrained by severe macroeconomic imbalances. Widespread poverty in Dominican Republic, Guyana, Haiti and Jamaica, as well as the fresh memories from severe bank failures in Barbados and Trinidad & Tobago, constitute important constraints. Firms in these countries obtain capital mainly from bank loans. In general, though, loan terms are very costly for borrowers, due to high reserve requirements but also to large bank overhead. Overall, there is acute market segmentation, with the private commercial banks being unwilling or unable to handle small size loans.

There are four stock exchanges in the region, in Barbados, Jamaica, Trinidad & Tobago and Dominican Republic. The exchanges of Trinidad & Tobago and Barbados are the most important, primarily active in the trading of government securities. None of the four stock exchanges report much offering of corporate equity and this will remain so until firm owners are willing to dilute control, incomes are raised, and investor confidence is regained

14 USAID's Bureau for Latin America and the Caribbean has a role to play in fostering financial policy reform in the Hemisphere. For better effectiveness, technical assistance programs must be properly coordinated with Washington-based multilateral banks. The following recommendations can be made:

First, the Bureau can facilitate a successful beginning for the Council of Securities Regulations of the Americas (COSRA), by carrying out a study, in close coordination with the Inter American Development Bank, in order to unveil information on what needs to be done to move forward the harmonization of rules of capital markets By the same token, the Bureau should propose studies aimed at harmonizing bank regulation and supervision norms. This task can be first approached regionally, probably the Central American region would be an appropriate starting point.

<u>Second</u>, the Bureau can contribute by undertaking complementary tasks that must accompany financial reform assistance packages. For example, technical assistance to reform legal systems is sorely needed in several countries. As regards the banking sector, the Bureau can offer resources to coordinate efforts aimed at strengthening the capabilities of supervisory agencies Programs of this nature promise very high returns, given the proclivity of banks to participate in so many *préstamos relacionados*, to overstate assets, and to withhold or doctor information that is vital for customers. Overall, the Bureau must contemplate offering Hemisphere-wide seminars on the most modern and updated techniques of bank supervision Similar seminars can also be offered on advanced techniques for the supervision of capital markets

<u>Third</u>, if scarce resources force only one alternative, either strengthening the banking sector or modernizing capital markets, the Bureau should unequivocally support the former One promising area for intervention relates to special programs on microenterprise lending that private commercial banks are implementing. Since this is very incipient, the Bureau can commission a study on "success stories", and offer Hemisphere-wide seminars on the conditions that make them possible Another area that promises high returns relates to the financial sustainability of commercial banks in times of economic transition and the design of adequate deposit insurance schemes Studies that pinpoint causes and conditions that trigger massive bank failure can be disseminated; in this regard, a good case study could be made out of the Venezuelan experience. By the same token, it is worthwhile to undertake comparative studies on the issue of deposit insurance, an area, we would emphasize, has not been adequately investigated by other donors.

<u>Fourth</u>, the Bureau can make a lasting contribution in financial policy reform through policy dialogue. Three specific areas stand out: (1) Regarding state banks, the Bureau can help governments redefine the role of these entities through country-specific reports If the decision is to liquidate, the Bureau can assist in preserving the state banks' customer files by setting up credit information mechanisms that can be used by other entities on one hand, and, on the other, in assessing the viability of transferring profitable branches in the countryside to cooperatives or rural entrepreneurs.

(2) Regarding the liberalization of deposit rates, the Bureau can assist countries in finding efficient mechanisms to ensure that these rates remain positive in real terms but, above all, stable. (3) In coordination with the Treasury Department and with the other Washington-based donors, the Bureau can contribute in finding ways to avoid the pitfalls from external liberalization.

CHAPTER ONE

Overview of Financial Reform in Latin America and the Caribbean

I Introduction

The literature on financial markets accurately recognizes Latin America and the Caribbean as a region that has traditionally relied on a *dirigiste* approach to matters of financial policy. At least until the 1980s, most of the countries of the Hemisphere still adhered to the notion that state activism was fruitful for the development of the economy in general and of financial markets in particular The underlying premise was that financial markets were imperfect. On the supply side, given the low levels of income, there was a perpetual scarcity of savings On the demand side, credit, a vital input of production, was normally designated by private bankers to relatively risk-free activities, mostly related to export and import transactions of well-known customers. As a consequence, according to this view, vast numbers of producers with substantial economic potential were *de facto* marginalized from the supply of financial services, which reinforced an economically and socially unacceptable distribution of income

This scenario created the need for state activism, oriented towards the elimination of key bottlenecks. For example, the government would play a role in increasing savings by implicit and explicit taxation, or by acquiring ownership and control of large enterprises that were depositories of substantial revenues and foreign exchange Another role would be played in the design of credit programs aimed at channeling loans to the benefit of agriculture, small industry, housing, and other activities that were traditionally shunned by private lenders In order to achieve this objective, governments would resort to a myriad of instruments, the most important of which were (1) high reserve requirements on bank deposits, (2) interest rate ceilings on deposits and loans, (3) rediscount facilities from the Central Bank to commercial banks for on-lending to targeted sectors, and (4) creation of specialized credit agencies, such as state development banks.

In fairness, there is no reason to suggest that state activism is ultimately destructive to financial markets. Joseph Stiglitz has convincingly demonstrated recently that the State must play a constructive role in financial markets.[1] In practice, all countries, whether fully developed, semi-industrialized or less developed, present features of state intervention in financial markets. Newly industrialized countries, in particular those in Asia that have been widely applauded as having achieved impressive economic growth rates in the last two decades -- Taiwan, South Korea, Malaysia, Thailand and Indonesia -- recognized finance as a critically important tool for economic development These countries either assigned the State the sole responsibility for the provision of financial services in the economy, or successfully combined doses of state intervention with measures aimed at expanding the role of private commercial banks In so doing, these countries made use of policy instruments such as massive lending from state-owned banks, targeted and subsidized credit, and government guarantee programs to achieve development goals. These are precisely the same policy instruments which permeated the financial landscape of the Latin American and the Caribbean until the 1980s, however, the results were radically different. In fact, in sharp contrast to the Asian countries, state activism in Latin America and the Caribbean led to and underlined a generalized process of financial disintermediation

A comparison of the ratio of M3 to GNP in selected Latin American and Asian countries illustrates this point.[2] A high ratio indicates a large real flow of domestic loanable funds for new investments During the period 1960-1985, the mean ratio for Argentina, Brazil, Chile and Colombia was 0 213, 0 171, 0 168 and 0 228 respectively. In the same period, the ratio for South Korea was 0.320 In Taiwan and Singapore, the depth of financial intermediation was even higher. By 1985, the ratio of M3 to GNP was 1 264 for Taiwan and 0.788 for Singapore. In addition, several empirical studies have demonstrated that there is a positive correlation between the growth of real financial assets -- defined as the sum of monetary and quasi monetary deposits with the banking sector, corrected for changes in consumer price indices -- and growth of real gross domestic product. In this regard, Asian countries, with superior growth rates of real financial assets for the last thirty years, by far surpass the performances of Latin American and Caribbean countries.

If not state activism *per se*, what accounts for the dismal performance of financial markets in Latin America and the Caribbean? Of several plausible explanations, four stand out. First, interventionist

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[1]Stiglitz (1992).

[2]This illustration is taken from McKinnon (1991) M3 is defined as money plus quasi-money plus deposits outside commercial banks.

policies in financial markets were implemented within a context of severe fiscal and monetary imbalances. The logical consequence of these imbalances was inflation, the curse of financial markets Second, as opposed to Asian countries where interventionist policies such as targeted and subsidized credit were part of an overall, coherent development strategy that greatly enhanced economic growth, in Latin American countries these policies were used as instruments to dispense economic rents to the benefit of special groups Third, Latin American civil service, in general terms, showed neither technical and managerial skills nor freedom from political interference, both of which are necessary conditions for an efficient implementation of complex policies. Moreover, in many Latin American countries, the civil service is viewed as an employer of last resort -- not as a prestigious vehicle for professional advancement. This, in combination with low salaries and long periods of political and economic instability, contributes to the formation of a civil service with low professional standards The most able usually leave and the remainder can be easily manipulated and coerced by special groups to their advantage Finally, the application of targeted and subsidized credit was extensive, constituting a large percentage of total credit portfolios. Inadequately managed and poorly monitored, these policies, in the end, led to widespread abuse, inefficiency and fraud.

By the early 1980s, the severe economic recession in the industrialized countries, coupled with the squeeze on output and income that was transmitted by the foreign debt crisis, unveiled the fragility of the economies of the region by exacerbating fiscal and monetary imbalances These imbalances, it must underlined, were a constant in many countries of the region, especially in those where persistent attempts at effecting large redistributions of income and assets, were foiled by policies that introduced severe economic distortions that ultimately choked growth By the mid-1980s, many countries exhibited runaway inflation and falling outputs All this forced academicians, public officials and private investors to reassess the role that the government had traditionally played in Latin America Stabilization policies aimed at correcting macroeconomic disequilibria were implemented In the specific realm of finance, the crisis brought into sharp reality the sorrowful state of the financial markets of the region. Against this backdrop, it was obvious that the financial sector in most of the countries was in need of a major overhaul. With the cooperation of multilateral donors, governments set about designing and implementing this very ambitious task.

A summary of the current status of financial reform in the hemisphere follows. After this, we catalog the existing economic and institutional constraints to financial markets in the region. Economic constraints include overall macroeconomic fragility, inequality, and the high cost of capital. The institutional constraints highlighted comprise state interference, inefficient legal and judiciary systems, excessive bank risk-taking, and inadequate supervisory systems

II. Status of Financial Policy Reform:

The expansion of financial markets is predicated upon macroeconomic stability, positive real interest rates on bank deposits, enforcement of adequate prudential regulations, and efficient supervision of financial entities. Implementing financial policy reform entails the adoption of several measures aimed at liberalizing the domestic market and at freeing international capital flows. These measures include the reduction of reserve requirements, market determination of interest rates on loans and deposits, the elimination or reduction of targeted and subsidized lines of credit, the privatization of state-owned banks and last, but not least, the removal of all barriers to entry that smother competition.[3]

These measures come out of a larger reform effort that has been launched in the region. Accomplishments to this date have been extremely significant. In fact, Westley's recent study, in which 1988 (for reasons of convenience) is the base year for reform, unequivocally shows.[4]

(i) Market determination of deposit rates have been introduced in Peru, Venezuela, Bolivia, El Salvador, Nicaragua, Ecuador, Guatemala, Dominican Republic, Brazil, Paraguay, Costa Rica and Guyana. If other countries -- Colombia, Uruguay, Argentina, Mexico, Trinidad & Tobago, Chile, Honduras, Panama, The Bahamas, Barbados and Suriname -- where market rates on deposits existed prior to reform period are included, the number of countries in which deposit rates are market-determined is 23

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[3]In large part, these measures subscribe to the standard policy recommendations that have evolved from the "financial repression" approach to capital markets. This approach was an answer to the *dirigiste* policies that prevailed in the 1960s and was pioneered by McKinnon and Shaw in 1973. The theoretical foundations of this approach have greatly influenced both the design and implementation of financial policy reform in Latin America

[4]See Westley (1995) This study has made invaluable contributions to our Report

(ii) Market determination of loan rates have been introduced in Peru, Bolivia, El Salvador, Nicaragua, Mexico, Guatemala, Dominican Republic, Brazil, Ecuador, Paraguay, Costa Rica, Honduras and Guyana The following countries abided by a market determination of loan rates before the start of reform period Uruguay, Trinidad & Tobago, Panama, The Bahamas and Suriname.

(iii) The following countries managed to reduce their reserve requirements on local-currency denominated bank deposits: Colombia, Peru, Venezuela, Bolivia, Uruguay, El Salvador, Nicaragua, Argentina, Mexico, Ecuador, Guatemala, Dominican Republic, Paraguay and Guyana.

(iv) The countries that lowered their reserve requirements on dollar-denominated bank deposits are: Colombia, Peru, Uruguay, El Salvador, Nicaragua, Argentina, Mexico, Ecuador and Trinidad & Tobago.

(v) The record on the reduction or elimination of targeted lines of credit is encouraging Peru and Guatemala have eliminated them altogether, whereas Colombia, Venezuela, Bolivia, El Salvador, Nicaragua, Argentina, Mexico, Dominican Republic, Jamaica, Trinidad & Tobago, Brazil, Paraguay, Costa Rica, Honduras and Guyana have reduced them either moderately or substantially.

(vi) Progress has also been reported in the process of privatization or liquidation of state-owned financial concerns. The following countries effected significant divestitures of some of these firms Colombia (1991-1994), Peru (1992-1994), Bolivia (1989-1991), El Salvador (1990-1993), Trinidad & Tobago (1990-1993), and Guyana (1991 and 1994). Mexico, in early 1994, completed the reprivatization of all of the banks that had been taken over by the State following the 1982 debt crisis On the other hand, the privatization effort in Argentina, Costa Rica, Uruguay, Brazil and Nicaragua has been generally very mild

(vii) Greater central bank independence has been reported in the following countries Colombia, Peru, Bolivia, El Salvador, Nicaragua, Argentina, Mexico, Ecuador, Guatemala, Jamaica, Trinidad & Tobago, Chile, and Costa Rica.

(viii) A new and modern capital markets law or set of regulations has been introduced in Colombia (1993), Peru (1993), Venezuela (1993), El Salvador (1994), Nicaragua (1993), Argentina (1991-1994), Mexico (1989), Ecuador (1993), Jamaica (1993), Brazil (1989) and Chile (1994)

(ix) A new and modern bank law or set of regulations was introduced in Colombia (1990 and 1993), Peru (1991 and 1993), Bolivia (1992), Uruguay (1993), El Salvador (1992), Nicaragua (1993), Argentina (1992-1993), Ecuador (1994), Guatemala (1992), Dominican Republic, Jamaica (1993), Trinidad & Tobago (1991), and Barbados (late 1980s)

(x) Systems for commercial bank supervision underwent major reforms in Peru, Uruguay, Bolivia, Trinidad & Tobago and Nicaragua. Some improvements have been reported in Argentina, Ecuador, Guatemala and Guyana On the other hand, Colombia, El Salvador, Chile, Brazil,[5] Belize and Bahamas are countries that allegedly did not need reforms in this area given the prior existence of adequate systems of bank supervision.

In all, while recognizing that bank supervision systems are in need of major or some overhaul in fifteen countries of the region, and noting that several countries need to set more reasonable capital adequacy standards, Westley, in his survey, unambiguously concludes that the region has made impressive achievements in financial reforms Furthermore, the survey also concludes that forthcoming policy changes will be in the positive direction, towards institutional strengthening on one hand and, on the other, away from the implicit and explicit taxation mechanisms, traditionally forced upon the region's financial systems in order to finance fiscal disequilibria The survey hails Colombia, Peru, Bolivia, Uruguay, El Salvador, Nicaragua and Venezuela[6] as the major reformers In a second category, of substantial reformers, are included Argentina, Mexico, Ecuador, Guatemala, Dominican Republic, Jamaica, and Trinidad & Tobago. The next class of reformers includes Brazil, Paraguay, Costa Rica, Honduras, Guyana and Chile [7] Finally, Belize, Panama, The Bahamas, Barbados, Haiti and Suriname are singled out as countries where practically no reform has been undertaken

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[5]Contrary to Westley's findings, this Report argues that Brazil's bank supervision system needs improvement

[6]Venezuela's inclusion among major reformers must be based -- at least as far as bank supervision is concerned -- on how reasonable the new laws looked <u>on paper</u> In practice, as 1994 painfully demonstrated, supervision was extremely weak

[7]Chile is included in this group not because it is a mild reformer, but because most of the reforms were implemented before 1988, the base year for reform that is used by the survey

III Existing Constraints·

There is no doubt that the scope of reform has been impressive. Nevertheless, it is not possible to declare with certainty that all these measures are conducive to establishing the foundations of solid financial markets which can add to and facilitate the task of economic development.

For one, strict adherence to the tenets of financial liberalization espoused by McKinnon and his followers offers no guarantees for success. To the contrary, the initial experiments with this approach to reform in Chile, Argentina and Uruguay, in the mid- to late 1970s, resulted in colossal failures In response, much was done in subsequent years to refine the theory, with particular emphasis on the design of a blueprint for a successful <u>sequencing</u> of financial liberalization. For example, it was postulated that domestic reform should precede the opening of the capital account, and that the liberalization of interest rates should neither be undertaken before correcting macroeconomic imbalances, nor without the presence of efficient bank regulation and supervision However, given the institutional weaknesses and fragile economic structures that characterize the Hemisphere, not even an appropriate sequencing of reforms can fulfill the promises of financial liberalization.[8]

Institutional weaknesses and fragile economic structures underline the presence of important constraints. In Latin America, each country exhibits a particular configuration of social, political, economic and even cultural characteristics that condition the behavior of financial markets and which, to some degree, define existing financial policy and its feasibility for substantial change For this reason, it is virtually impossible to identify a set of constraints on financial markets that is common to all the countries of the region Similarly, it is unreasonable to arrive at conclusions and recommendations that can be applied region-wide

Nevertheless, the region offers some distinct features with relevance for financial markets that differ markedly from those existing in industrialized and Asian countries, where the degree of sophistication and depth of financial intermediation is far superior. What follows, consequently, is an attempt to condense such regional features into stylized facts and to show how they constitute important impediments for the expansion

[8]A critique of the McKinnon school, the ruling paradigm of financial policy reform, lies beyond the scope of this Report For a succinct, penetrating insight into this issue, see Akyuz and Held (1993)

and development of financial markets Although they overlap, these impediments fall generally into two categories, economic and institutional

A Economic Constraints

Financial markets in Latin America and the Caribbean are hampered by the following economic constraints:

1. Overall Macroeconomic Fragility

The dynamism and solidity of countries' financial systems are directly related to the strength of their economies. On the whole, the Latin American and Caribbean economies are not stable and exhibit glaring weaknesses

With the exception of Chile and possibly Colombia, the region is permeated by economic fragility Chile, following the consistent application of far-reaching and comprehensive reforms in the 1980s, seems to be on its way towards sustained economic growth Colombia, in spite of a pervasive climate of social and political violence, has grown steadily since the 1960s by avoiding fiscal and monetary imbalances. Recent events underscore the tenuous atmosphere in the rest of the region. To wit, Mexico, in one year, will endure a drop in domestic demand by 11 percent and a fall in GDP by 5 percent This is the price to pay for a draconian economic adjustment program that calls for a reduction of the current account deficit from 8 percent of GDP to 2 percent. This brutal contraction of the economy will have severe consequences for Mexico's banking sector. Argentina, following the aftermath of the Mexican crisis, suffered bank runs and capital flight and is also headed for a severe economic recession after four years of steady growth Brazil also suffered the fallout from the "tequila effect" and was forced to devalue the real in an effort to halt a growing trade deficit Venezuela, since the emergence of the banking crisis, is in a downward spiral, and it is only the substantial oil revenues that prevent the economy from unraveling In Central America, Costa Rica is headed for a sharp recession, while no significant recovery is expected in Nicaragua, and Honduras will probably repeat its disappointing economic performance of 1994

The region is economically fragile because of its vulnerability to external shocks In fact, this is a historical constant. Unlike the recently industrialized countries of Asia, the Latin American and Caribbean countries have not been very successful at diversifying their export base Their export products, in the main, consist of raw materials which, since the late 1970s, have not enjoyed strong demand in international markets. Primary goods, in fact, constitute the slowest growing market in the world. Not surprisingly, the terms of trade for the region have deteriorated, with the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) estimating that, in comparison with 1980, the terms of trade in 1994 worsened by 29 percent

Persistently adverse terms of trade bear significance for financial markets through the impact they exert on the fiscal accounts. In weak economies, it is not at all uncommon that fiscal deficits rise rapidly as a result of a severe deterioration of the terms of trade. Under the usual circumstances, in which the deterioration is unexpected, it is very tempting for the government authorities to dispense implicit or explicit taxation on financial intermediation as a way of buffering this shock. The typical method of implicit taxation is to increase the level of reserve requirements. By this measure, banks are forced to "park" funds at the Central Bank which, in some countries, earn little or no interest, thus restricting the banks from channeling funds into higher-yield projects To compensate, banks usually resort to increasing effective loan rates and reducing deposit rates, which distorts interest rates This, in turn, crowds out the private sector in the real economy. Another type of implicit taxation is to force banks to acquire government securities that yield below-market returns, a method currently practiced in Venezuela. In truth, this measure was more common in pre-reform times in most countries Presently, as illustrated by the cases of Brazil and Costa Rica, governments seek to finance the fiscal deficit by offering banks very high yields on the purchase of government securities. Banks do this voluntarily, but there is potential for overinvestment in these securities which, ultimately, also crowds out the private sector in the real economy

The vulnerability of the region to external shocks is nowhere more conspicuously demonstrated than in the dependence on foreign capital In fact, another historical constant of the region is over-borrowing in international financial markets, followed by severe economic trauma when foreign loans dry up or when the flow of funds turns negative In recent times, this has been painfully revealed with the emergence of two major foreign debt crises (in 1982 and 1994) The root of the problem is the poor gross savings ratio.[9] On average, the region saves the equivalent of 17 percent of GDP, which compares poorly with the 38 percent that Asian economies

[9]For a detailed explanation on why savings rates are low in Latin America, see Edwards (1995).

generate. Furthermore, traditionally, foreign loans were not channeled to high-yield projects To illustrate, during the 1970s, in many Latin American countries the bulk of borrowing was captured either by inefficient state-owned enterprises or by a private sector that overinvested in non-tradeables activities or simply stored vast financial resources in foreign banks. Indeed, while these countries were struggling with hefty debt payments during the 1980s, South Korea, as heavily indebted as any of the large Latin American countries, was spared from the negative effects of the crisis due to prior, impressive efforts at developing its export sector

The low gross savings ratio and inefficient investments are direct causes of the relatively high cost structures that plague the Latin American economic landscape Increasing cost competitiveness is a must that requires not only committed efforts at inflation control, but also an all-out drive to increase total factor productivity through better health, improved skills and sustained work effort of management and labor, upgraded primary education and adoption of technical progress These are investments that have been neglected in the region and that largely explain the substandard performance of the economies, since at least the late 1960s. More importantly, this neglect, to a large extent, has caused the in-country distribution of incomes to deteriorate significantly. In effect, by denying poor people access to health services and upgraded primary education, the policies of exclusion have made all but impossible the entry and productive participation of the vast poor in domestic and international markets

Weak economic performances are also associated with the tendency for real exchange rate appreciation which, when severe and persistent, can have profound effects for financial markets [10] During the period 1990-1994, this tendency was exacerbated in Latin America and the Caribbean, while Asian countries, on the other hand, experienced real exchange rate depreciation -- notwithstanding that both regions benefited from the substantial capital

[10] One unfortunate side effect is capital flight. Another equally negative possibility is currency speculation. For example, under a regime of a fixed exchange rates, firms, in anticipation of devaluation, will increase their demand for credit in domestic currency to finance the build-up of imported goods By the same token, inventory costs will also be increased as firms delay the shipment of exportables Consequently, loan interest rates will increase. This trend is aggravated when bankers hedge against exchange rate devaluation by charging a premium on the loan rates. What usually happens is that loan rates will be pushed up even further, to some percentage points above the estimated overvaluation An alternative procedure is for bankers to demand that borrowers accept loans in domestic currency which are indexed to the value of the dollar This practice is currently common among commercial banks in Argentina. Unfortunately, this option is not risk-free, as borrowers may become insolvent with a devaluation

inflows that dominated transactions in emerging markets in that period This fundamental difference can be explained by the perception of foreign investors and, more significantly, by the observed pattern of their investments. As a rule, reflecting perhaps the cost competitiveness of the economies, the return on real assets in Latin American countries is substantially lower than in Asian countries For financial assets, attesting perhaps to the relative scarcity of domestic savings, the reverse is true: Latin American financial instruments offer far higher interest rates than Asian securities [11] Consequently, and not surprisingly, up to 70 percent of the most recent capital inflows in Latin America took the form of portfolio investments in equity, bonds or loans, of which a good part corresponded to so-called "fly-by-night" capital and which largely contributed to the appreciation of exchange rates.

2 Glaring Inequality

In the past, Latin American and Caribbean countries have applied development strategies that contributed to the marginalization of vast parts of their populations. The consistent application of policies of exclusion ultimately resulted in the emergence and strengthening of so-called dual economies consisting of (a) a formal sector, which operates in the "modern" economy, where impersonal exchange and market institutions generally prevail, and (b) an informal sector, characterized by underdeveloped market institutions and where personal relationships are normally the rule. The formal sector, with substantially higher levels of productivity and income, determines the overall pattern and dynamism of economic development

This dual economic structure underlines an uneven income distribution The consequences for the banking sector could be quite severe, especially when, as is the case of Latin America, income distribution is highly skewed To see why this is so, consider a process of trade liberalization which opens opportunities for local firms to upgrade production techniques by way of enabling them to import capital and intermediate goods Banks and other financial entities will naturally gravitate towards these firms However, a widespread process of industrial reconversion is suspect in economies characterized by an exclusionary pattern of economic development, as the benefits of trade are multiplied out The vast number of producers in the informal sector face high costs of market entry, and they are generally

[11] This point, as well as others related to comparisons between Asia and Latin America, were elaborated by the World Bank's Uri Dadusch, at the Summit of the Americas, celebrated in Miami in December 1994

constrained by outdated technologies. Hence, the most dynamic firms bypass these local producers as a source of inputs and look to the import market instead This triggers an over reliance on imports, exacerbated by the fact that the prevailing income distribution in Latin America and the Caribbean gives way to a demand profile dominated by high and middle income groups who have historically indulged in the over consumption of foreign products or local goods with high-import values. The over-reliance on imports leads to persistent, large trade deficits. When governments try to rectify the ensuing balance of payments crises by devaluations, many banks suffer because so many borrowers then find themselves unable to meet debt payments

This economic structure affects the development of financial markets in other ways. First, the acute segmentation of markets ultimately prohibits the advantages that result from specialization and economies of scale. For example, the informal sector is handicapped by the lack of institutional infrastructures which are critically important for the development of finance, such as mass-based information-sharing networks, and reliable, predictable mechanisms for the enforcement of credit contracts. Under these circumstances, lenders gravitate towards personalized transactions and strive to locate borrowers individually. However, this is very costly and inefficient Moreover, finance in the informal sector does not provide for a safe, convenient, and sustained process of savings mobilization Given the lack or inadequacy of physical facilities, such as road and transportation networks, combined with a shortage of banks themselves and a restrictive flow of information, the bulk of savings that the sector generates takes the form of non-financial assets Finally, it must also be emphasized that the informal sector, generally speaking, remains separated from the well-established, privately-owned financial entities which comfortably earn substantial rents from operations in the formal economy These entities have developed financial products that are supplied on the basis of costly project appraisal techniques and collateral requirements, factors which limit the clientele they are willing to serve. In combination with the difficulty in assessing the creditworthiness of potential "informal" customers, these procedures, when applied within the context of the marginalized clientele, render loans and other financial products prohibitively expensive and unprofitable. This emphasizes and reinforces an unpleasant reality in the Latin American context, financial transactions seldom contribute to the integration of markets

In addition, an uneven income distribution aggravates social and economic instability A vicious circle ensues since the more socially and economically unstable the country, the more prone are wealthy groups to diversify their investments, which includes capital flight, without a doubt one of the major impediments for the development of Latin American economies In the past, Latin American countries have tried to contend with the problem of capital flight by enacting exchange controls which have proven to be largely ineffectual Past, ill-conceived attempts at income redistribution also failed because they fueled high inflation. As a consequence of higher inflation, speculation increased, as did capital flight from the well-to-do, while the underprivileged developed the tendency to save in the form of non-financial assets.

3 High Cost of Capital [12]

A high cost of capital is a serious problem that endangers free trade policies because firms find that high financing costs undermine their competitive position *vis-a-vis* foreign rivals This problem is very serious in Latin America, as evidenced in several countries in which local firms have found it cheaper and more convenient to seek financing from foreign lenders. This option, naturally, has not been available for the vast majority of local firms whose only alternatives have been to either absorb the finance costs or simply shelve any investment plans.

Two factors help maintain the relatively high cost of capital in Latin America First, it reflects the fundamental fact that the process of macroeconomic adjustment has not been completed.[13] Until public sector deficits are reined in, interest rates will remain high and inflation will persist. This problem is mollified in countries like Argentina and Peru, where substantial revenues generated by the divestiture of state-owned concerns keep the fiscal accounts in surplus. Countries like Bolivia and Nicaragua can finance large fiscal deficits in non-inflationary ways due to the cooperation from foreign donors. However, the perception that public sector reform has only barely started in most of Latin America translates into

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[12] We are thankful to Hemant Shah, Senior Financial Economist of The World Bank, who provided valuable insights on this constraint.

[13] Nowhere is there stronger evidence of this point than in the trend for dollarization that is so visible in several countries. In essence, the process of dollarization underscores the reality that the government has lost credibility in the eyes of economic agents. Dollarization serves the purpose of assuring people that they will not be penalized *via* inflation tax In the best of all possible scenarios (as opposed to the "Panamazation" of the economy, i.e, the surrender of monetary policy to the U S. Federal Reserve), dollarization serves to hold the economy over until there is sufficient trust in the country that warrants confidence in the local currency Dollarization is particularly severe in countries with a memory of high inflation

inflationary expectations. Furthermore, this is worsened by the evolution of current account deficits, which lend credence to the fact that the adjustment process is not finished. In the most recent period of economic growth, from 1990 through 1994, liabilities to foreigners rose faster than exports in the largest Latin American countries.[14]

The expectation for future inflation, combined with the expectation for exchange rate depreciation (grounded on growing current account deficits), is evidenced in the premium that bankers charge on loan rates An even more important factor that explains the high cost of capital lies in the large intermediation margins that characterize Latin American banking. In fact, abnormally high spreads are a feature in these markets with the unfortunate consequences that (a) financial systems do not make the best use of scarce domestic savings and (b) some potentially beneficial uses of investment funds are discouraged. High intermediation margins are intimately associated with high operating costs -- resulting from over-branching, high reserve requirements, and high loan losses -- as well as with oligopolistic market structures In fact, high intermediation margins signal the existence of economic rents and, consequently, of financial market structures that significantly depart from the competitive ideal. The presence of oligopolistic market structures is precisely one of the major problems that affects the financial markets of several countries of the region. Despite the recent advances made by the region in the adoption of modern bank laws, in the sell off of state-owned financial concerns, and in the promotion of entry of new participants, there is the latent possibility that the regulatory frameworks that govern financial activities may be enacted to deny, in practice, a climate of open competition.[15]

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[14]Uri Dadusch has estimated that this problem was particularly severe in Mexico and Argentina, but less so in Chile and Brazil, the star export performers in the Hemisphere. Even those two countries, however, could not match the performances of the Asian countries.

[15]In several countries, banks act as cartels and exercise powerful influence in economic decision making. In Honduras, for example, the Bankers' Association resisted the approval of a new law of financial modernization for quite some time. After much prodding from multilateral donors, the law is expected to be approved soon by Congress, but there is concern that the regulatory framework will not promote more competition in the industry Huge rents accrue to the banking sector of this country· in 1994, while the economy contracted by 1.5 percent, the financial sector registered a 4 percent growth rate

B. Institutional Constraints

The following institutional constraints impede financial markets in Latin America and the Caribbean

1 Misguided Government Intervention.

The development of financial markets in the region is impeded by faulty government intervention The presence of state banks is a case in point. Originally established as conduits for the delivery of targeted, subsidized credit, these entities seldom performed well. In the end, they merely acted as vehicles for handing out credit from central banks. They became hopelessly decapitalized as the inflationary process that normally accompanies the unlimited use of rediscount privileges eroded the real value of their loan portfolios.

At present, and considerable as they still may be in some countries, the principal problem does not primarily lie with the losses that these entities incur. Far more important is the fact that in most countries, the state banks are sources of important distortions, as they price their products capriciously, and are not subject to the reserve requirements that are applied to the private banks The role, if any, that state banks should play, needs to be redefined in almost all countries of the region Ideally, especially in those countries with important regions that are perpetually shunned by the largest private commercial banks, state banks could play a developmental role as long as they are properly managed and free from political interference What currently exists in the Hemisphere, however, is hardly conducive to the better health of financial markets In Brazil, for example, the state banks are a vehicle for the dispensing of political patronage, and the Central Bank is mandated by law to keep the banks afloat through unlimited rediscount lines. Such lines have now been suspended to Argentina's provincial banks but, in a bid to obtain funds, some of them are competing to capture deposits from the public -- with the consequence of dramatically increasing deposit rates. In Nicaragua, the BND (Banco Nacional de Desarrollo), which is the largest state bank, was recently restructured, yet there are no signs that it is operating more efficiently Moreover, its new management has allegedly adopted a profit maximization philosophy, consequently, the BND may tend to neglect activities traditionally ignored by the private banks. Finally, in Costa Rica, two large state banks still dominate the market Their explicit inefficiencies are of great benefit for the private banks which operate along side them: the private banks can capture deposits and make loans at the same rates priced by the state banks but, since they are much more efficient, they can earn substantial rents.

Misguided state intervention also manifests itself in the enactment of high reserve requirements which, naturally, are closely associated with the overall macroeconomic fragility that the region endures Whether they serve the purpose of financing fiscal deficits, of funding central banks' rediscount credit lines, or stemming a flight to other currencies, high reserve requirements contribute to the segmentation of financial markets This is evidenced by the emergence of parallel or informal markets where these restrictions do not apply and where a vast number of financial transactions are carried out In Honduras, for example, the volume of transactions is higher in informal markets than in the formal market. Offshore banking, a widespread practice in Central America, the Caribbean and Venezuela, also represents attempts to avoid the implicit taxes that high reserve requirements impose. Finally, it is worth mentioning the case of Brazil In this country, there are different types of reserve requirements, according to region, type of bank and type of deposit. This system creates important distortions at the macroeconomic level since banks, in a bid to avoid the implicit taxation, move funds from a region where reserve requirements are high to a branch in another region where these are low. This, in combination with the changes from one type of deposit to another, creates shifts in the money multiplier and therefore makes effective conduct of monetary policy more complicated.

2. Inefficiency of Legal and Judiciary Systems

This is perhaps one of the major constraints for the development of financial markets In several Latin American countries the rights of lenders are not properly protected. In general, the law implicitly favors borrowers because actions to exercise guarantees in the event of loan defaults are often tedious and costly [16] Even when foreclosing is enshrined in law, however, exercising this right is virtually impossible, since the judiciary is incompetent, inefficient, unpredictable, and usually corrupt Therefore, it is not unusual for financial entities to charge a premium on loan rates that would cover possible losses As a result, the cost of capital is increased further For these reasons, actions aimed at reforming these systems are of utmost urgency

The inadequacy of the legal and judiciary systems also relates to

[16] One extreme case is provided by Uruguay In this country, the law prohibits banks from foreclosing collateral

two other important problems The first is that legal and regulatory frameworks in several countries do not obligate banks to disclose relevant information to the public. The second is that there is lack of enforcement of prudential norms and regulations, including capital adequacy ratios and the provision of reserves against loans of doubtful recovery Many experts interviewed agreed that "there is no teeth in enforcement." This is explained not only by inherent institutional weaknesses, but also by the logic of local politics. In Bolivia, for example, there is concern that if prudential norms were enforced strictly, many banks would collapse, thus possibly unleashing a systemic crisis that would be politically costly for the government In addition, political considerations played a big role in the faulty approach that the Venezuelan government adopted to tackle the banking crisis.

3. Tendency of Banks for Risky Behavior:

Latin America, in recent years, offers a rich sample of banking systems in distress. In fact, as reported by the World Bank:[17]

(i) In the early 1980s, following the failure of a large private bank, Argentina liquidated almost a fifth of its financial entities.

(ii) Also in the early 1980s, as much as 80 percent of Chile's total financial assets were either liquidated or taken over by the State, following the collapse of private commercial banks The Central Bank took over uncollected receivables from these entities, for an amount equivalent to 19 percent of GDP

(iii) In Colombia, in 1985, the losses of the entire banking system amounted to 140 percent of capital plus reserves. The Central Bank had to intervene in six banks whose assets totaled 24 percent of the system.

(iv) In Bolivia, in 1987, the Central Bank liquidated two private banks, while in 1988, arrears of the private commercial banks stood at 92 percent of their net worth.

This list does not exhaust the cases of major financial crises

[17]See World Bank (1990).

that have struck the region in recent years. The Uruguayan banking system collapsed in the early 1980s. In Peru, in 1992, the Ministry of Finance had to rescue a large number of banks and other financial entities Finally, two recent events should not go unnoticed the first is the catastrophic banking collapse in Venezuela in early 1994, with reported losses equivalent to 16 percent of GDP, and still rising The second, and most recent, is the Mexican crisis of late 1994 Although the information is sketchy, reliable sources in this country are already pointing to huge losses in many banks

In fairness, it must be stated that banking crises are a natural and, to a limited extent, healthy, part of a market society. They emerge in developed and less developed countries alike due to a variety of reasons. exogenous economic shocks, sudden downturn of the economy, balance of payments crises, poor management decisions, fraud, and so forth However, in the Latin American context, two features seem to be of particular relevance. the first is the magnitude of the crises. As significant as the losses from the Savings and Loan fiasco in the United States were, under no circumstances can they be compared, in relative terms, with the major financial debacles that some Latin American countries have had to shoulder. In this region, losses must be measured not only by their weight in GDP and by the economic opportunities lost as a result of misguided investments, but also by the unavoidable breach of public trust that crises engender Far from being a simple matter, public trust is of enormous relevance for a region that, in general terms, has not distinguished itself either for the promotion of domestic savings, nor for the adoption and enforcement of rules aimed at safeguarding the liquidity of the entire financial system and at protecting the safety of deposits The second feature lies in the propensity for major financial crises to recur the Mexican state, in 1982, took over the banks after a major crisis, reprivatized them in the early 1990s, only to see them totter again in 1995, the banking system in Argentina, presently, is "clinging by its fingernails".

What then accounts for these two particular features? While the above-stated characteristics are important factors, the tendency for banks to undertake risky behavior is perhaps the most vital cause.[18] This is evidenced in the substantially above-market rates on deposits to cover liquidity needs, and also by decisions to offer loans to risky borrowers at above-market interest rates. The reason banks undertake this risky behavior is that there are incentives for them to do so These incentives are basically expressed in the presence of three conditions The first is low capital adequacy ratios

[18] Kim Staking, an Inter American Development Bank official, provided useful insights on this point

if banks are undercapitalized, owners and managers feel that they have nothing to lose and, therefore, will not necessarily exercise prudence in lending decisions. The second is the existence of implicit deposit insurance which encourages moral hazard on part of banks In other words, banks are confident that if they make bad loans, the government will ultimately bail them out Finally, many economies are characterized by the lack of a system that can guarantee adequate supervision of financial entities.

4. Inadequate Supervision Systems:

In several Latin American countries, supervisory agencies of financial entities are over-staffed and under-budgeted It is not uncommon for the staff of these agencies to be underpaid, which breeds the potential for corruption. Furthermore, many staff lack adequate training As a result, the entire supervisory system may be permeated with a lack of motivation and overall demoralization.

While supervisory agencies in several countries have sustained major reforms or are currently in the process of improvement, focus must be placed on three important changes. The first is to shift from a traditional auditor's approach to supervision towards one which embraces the complexities inherent in today's financial markets The banking industry has sustained a radical transformation in the last twenty years, the results of a generalized process of deregulation, globalization, faster communication and product innovation The traditional auditor's approach, which relies on financial ratio analysis and examination of financial statements, is thoroughly inadequate. Today, supervisors must be well versed in banking techniques as well. The second improvement in supervision recognizes that a system that provides early warning signals would be of immense value in a region in which supervision has historically been *ex post* Indeed, colossal bank failures, in large and small countries alike, could have been prevented if supervisory agencies had adopted more efficient systems to detect bank mismanagement. Finally, permanent training programs to upgrade skills and better pay are necessary for effective financial supervision.

Supervision is a matter of utmost importance especially when regulatory frameworks of financial systems enable commercial banks to invest in other financial activities -- such as brokering, insurance, investment banking, leasing, and factoring -- or even in industrial concerns Several Latin American countries, such as Argentina, Peru, Bolivia, Ecuador, Mexico and Venezuela, for example, allow for this type of banking When faulty, inadequate supervision is the rule, and when banks are undercapitalized, the dangers for the financial system are monumental because banks can ultimately take deposits from the public to finance their interlocking businesses In Honduras, for example, the average banker enters the banking business not for banking profits, but in order to finance his other businesses Not surprisingly, in this country, as much of 1,300 percent of average banks' capital is tied in the so-called *préstamos relacionados*[19] This compares very unfavorably with the 25 percent that prevails in El Salvador, a country with a much more adequate supervision system. The problem is compounded with the presence of implicit deposit insurance, for when the Central Bank steps in, the public funds are used to cover not just deposits from banks, but losses from the other entities that belong to the holding as well This happened in Chile in 1983, in Venezuela in 1994 and it could probably happen in Mexico.

IV. Summary

While the pace of policy change has been impressive, the reform effort is far from over. The development of financial markets in the Hemisphere will remain an illusion unless governments take decisive steps to overcome the aforementioned economic and institutional constraints

As regards financial markets in particular, governments should intervene only if they have the capacity to do so effectively and if there is reasonable certainty that social returns will outweigh the costs of intervention. Admittedly, these conditions are very difficult to ascertain *ex-ante*. Indeed, the serious excesses of past, faulty interventions in the Hemisphere taught many painful lessons Today, these lessons serve as a base from which efforts aimed at a better design and implementation of financial policies can be undertaken

Above all, governments should embrace pragmatism, all the more necessary given that the adopted conventional financial policy reforms will have *per force* a limited impact because of the presence of the constraints More importantly, a pragmatic approach will enable policy makers to realize that unintended, unwelcome consequences may result from a careless application of these policies. To illustrate, consider the possible impact from the liberalization of interest rates on deposits. As noted before, empirical studies for a number of countries in different regions demonstrate that there is a positive correlation between the growth of real financial assets and

[19] *Préstamos relacionados* refers to loans made to banks' owners, and their relatives and/or business associates

growth of real gross domestic product Yet, in Latin America, often interest rate liberalization has not increased investment, contrary to expectations, it has spurred borrowing for speculation in financial and real assets, and increased consumption.[20]

Finally, a point that must be stressed in light of recent developments. nowhere is the need for pragmatism more vividly expressed than in policies pursued with respect to the capital account. After the long pursuit of restrictive policies, many Latin American countries, since the late 1980s, reversed direction and embraced external liberalization, purportedly to attract capital inflows. They largely succeeded in doing so, but the nature of the inflows were generally short-term. Stock markets flourished, yet little attention was given to the fact that the resulting currency overvaluation established a phenomenal conflict between the goals of foreign investors and those of long-term development [21] Mexico, for one, was unable to avoid this brewing crisis The Chilean economy, on the other hand, which exhibited strict controls during the same period in order to prevent the capital inflows from undermining real exchange rate competitiveness, emerged from the crisis largely unscathed.

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[20]There are other possible consequences from the liberalization of deposit rates which may exacerbate the aforementioned constraints. First, freeing deposit rates may aggravate income distribution and market segmentation. This would happen if, for example, liberalization results in abnormally high interest rates which cause a severe economic depression Furthermore, it is entirely plausible for lenders in the informal sector to increase deposits in formal financial entities and thus decrease lending and/or increase loan rates to their informal customers Second, if interest rate liberalization takes place in an economy characterized by overall allocative inefficiency, large involuntary defaults may follow The unfortunate consequence would be precisely to aggravate the severity of one of the plagues of financial systems of the Hemisphere, the high spreads This happens because banks normally pass the cost of bad loans to customers. Last but not least, a dramatic increase in interest rates may unleash a war to attract deposits This may well induce banks to acquire high yield assets -- including stocks and securities with volatile prices -- of doubtful quality and/or to enter new businesses on which they have little or no experience Akyuz and Held (1993) provide an interesting analysis of these and other scenarios

[21] This conflict was dramatically expressed in the Mexican crisis The more financial resources foreign investors poured into peso-denominated stocks and bonds of this country, the more they tacitly demanded a "strong" peso to realize profit expectations Apparently, the economic authorities did not seriously consider the fact that the ensuing overvaluation underlined an irrational structure of relative prices As a striking example, it actually became cheaper to import tortillas and tacos than to produce them domestically, which naturally handicapped small domestic producers

CHAPTER TWO

Financial Markets in the Hemisphere: Strengths and Weaknesses

This chapter describes the basic features of financial markets in the Hemisphere. The most critical issues related to policy, the banking sector and capital markets will be analytically discussed with the purpose of highlighting the strengths and weaknesses of these markets. For matters of convenience, countries are grouped into four regions: Central America (Panama, Costa Rica, Nicaragua, Honduras, El Salvador, Guatemala and Belize); the Andean countries (Venezuela, Colombia, Ecuador, Peru and Bolivia), Mercosur (Brazil, Argentina, Uruguay, Chile and Paraguay), and the Caribbean (the Dominican Republic, Haiti, Trinidad & Tobago, Guyana, Jamaica, The Bahamas and Barbados).

I. Central America

In this region, El Salvador clearly stands out as a major reformer and may be taken as a model for other countries In recent years, Guatemala has introduced positive measures. Nicaragua has also made important reforms, but these are imperiled due to political disarray and to a structurally weak economy that shows no signs of significant recovery from the devastation of war and the misguided policies of the last decade. Honduras and Costa Rica seem to have regressed, while the financial markets in Belize, to this date, seem to be very weak Due to its characteristics as a international banking center, Panama is a special case.

A. Policy Issues

These include macroeconomic stability, the commitment to privatization of state banks, determination of interest rates, and rediscount facilities.

1. Macroeconomic Stability·

The macroeconomic situation has deteriorated significantly in <u>Costa Rica</u> The fiscal deficit soared from 1 5 percent of GDP in 1993 to approximately 8 percent in April 1995 In order to finance it, the government has issued bonds that are bought voluntarily by commercial banks because the interest rates they pay are very high One problem is that the maturity of these bonds is very short term This, in combination with the stabilization bonds that the Central Bank issues to contract liquidity, has sent interest rates skyward [22] The economy, consequently, now suffers the classic problem of crowding out Severe recession and financial distress lie ahead, since large firms are being squeezed by high financing costs. There exists a strong possibility that some of these firms may find themselves unable to meet debt service payments, with the consequence that commercial banks may see their loan portfolios deteriorate.

High inflation and an overall climate of political and economic uncertainty have increased the trend for the dollarization of the economy The government authorities have established a 100 percent reserve requirement on dollar accounts. Given the present circumstances, this may be a sensible course of action, since it bars banks from using these funds to increase risky lending. Very high reserve requirements on demand deposits and on time deposits for less than 30 days have also been imposed to stem a flight to the dollar and to finance quasi-fiscal deficits of the Central Bank that date back to the 1980s These reserve requirements constitute a heavy implicit taxation on banks.

To sum up the overriding policy priority in Costa Rica is to substantially reduce the fiscal deficit. A recently signed political pact between the two dominant parties has paved the way for austerity measures If progress is made on this, total government expenditures will be contracted. It will consequently be feasible to reduce reserve requirements and, as a result, financial markets could plausibly increase intermediation to the benefit of the real economy In the mid- to long-term, however, it is imperative that the country undertake credible public sector reform aimed at exercising strict controls on its fiscal accounts. In the past, this urgency was not apparent, given the substantial flows of foreign aid that Costa Rica received. Today, however, the country no longer enjoys this benefit.

<u>Nicaragua</u> and <u>Honduras</u> also exhibit severe fiscal fragilities By the end of 1994, their fiscal deficits, measured as a percentage of GDP, were 8 percent and 7 percent respectively In <u>Nicaragua</u>, the deficit is financed almost entirely with foreign aid In the long-run, the deficit is not sustainable The situation is compounded because the productive structure of the country remains very weak and generally uncompetitive *vis-a-vis* other

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[22] In mid-May of 1995, deposit rates were 10 percent in real terms, while those on loans were above 20 percent.

countries of the region With sluggish growth (the accumulated growth rate of real GDP was 1 9 percent in the period 1991-1994, and -12 4 percent in per capita terms), tax revenues cannot be increased significantly. With respect to expenditures, a decision to enact large cuts would definitely increase social unrest, possibly unraveling the currently tenuous political peace.

In the case of Honduras, a decline of foreign aid in 1994 forced the government to introduce severe austerity measures in order to reduce the fiscal deficit, which by mid-year had ballooned to 11 percent of GDP. A reduction of current expenditures and contraction of public investment, however, were not sufficient, so the government had to resort to direct monetary expansion to finance part of the deficit As a consequence, inflation rose to 28 percent and a flight to the dollar followed. The government tried to stem this by raising reserve requirements to 34 percent, which earn no interest and thus constitute a heavy tax on the banking system

The large fiscal deficits that these two countries exhibit definitely hinder the expansion of financial markets. However, proposals that call for their radical elimination in a short time frame are simplistic A radical downsizing of the State in these small countries could well trigger political violence, social unrest and economic chaos Unfortunately, the existing fiscal deficits are more than the expression of macroeconomic mismanagement they also reflect the political influence of powerful economic groups which thrive in rent-seeking activities and which must be reconciled with the claims of all those which, justly or unjustly, feel they are *de facto* marginalized by an overall development strategy which condones an unacceptable distribution of income. In all, this is a delicate balancing act, with the government overseeing not a process of economic growth, but overall economic deterioration, in which socially desirable investments are not the rule. Under these circumstances, large fiscal deficits, seen as a recourse to freeze social tensions temporarily, are symptoms of the lack of viability that the present socio-economic structures of these two countries feature in the long run. The development of financial markets will follow once these conditions of political economy change.

Guatemala and El Salvador are two countries that in recent years have consistently avoided large and unsustainable fiscal and monetary imbalances Guatemala has launched an important tax reform that will lead to higher revenues through increased income taxes and value-added taxes, while improving the mechanisms for tax collection. These measures, in combination with expenditure cuts, will drive the fiscal deficit down to 0 5 percent of GDP in 1995, following the trend observed in 1994. With reduced claims on economic resources, the government managed to lower reserve requirements in 1994 by seven and a half percentage points which, in turn, helped to reduce lending rates by 6 percent.

El Salvador, with a fiscal deficit of just 1.5 percent of GDP, does not present significant fiscal disequilibrium either. But the move towards the implementation of a *Caja de Conversión*, which would signal the complete dollarization of the economy is, at this point, a source of concern. The plan for a proposed "Panamazation" of the Salvadoran economy will be implemented allegedly in mid-1996, though the exchange rate of the conversion has not yet been determined The problem is that the colón, for some years, has been overvalued due to substantial capital inflows [23] Even if the conversion is effected at a fixed exchange rate of 8 colones per dollar, which presumably would spare exporters from overvaluation, real appreciation may loom ahead, particularly if local inflation surpasses that of its main trading partners. In terms of the future evolution of the Salvadoran economy, one observation should be noted Notwithstanding its impressive achievements in recent years, the export sector has been lagging. The value of total exports in real terms stood at 77 percent of what was obtained in 1980 Imports, on the other hand, have been steadily growing The resulting substantial deficits in the trade balance and in the current account can be financed by borrowing and by the significant remittances from Salvadorans living abroad. If implemented, the *Plan de Conversión* would probably underline the drive to turn El Salvador into an international financial center that would rival Panama. Nevertheless, this would be built upon a very weak economy, basically constrained by an undeveloped productive structure and, consequently, utterly dependent on foreign capital inflows.

2. Privatization:

El Salvador is the country that has advanced most in this area Between 1990 and 1993, it managed to privatize or liquidate as much as 95 percent of the total loan share held by public financial entities Nicaragua lies at the other extreme. In this country, three state banks hold as much as 75 percent of the total credit portfolio of the system Of these, the BND is the largest and was recently restructured, but it is clearly in trouble Total arrears approximate 30 percent of the portfolio, a conservative estimate

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[23] By the end of 1994, the colón/dollar real exchange rate applicable to Salvadoran exports had appreciated by 17.2 percent since 1990 Within the Central American region, Guatemalan exports also suffered from overvaluation, while there has been a real undervaluation in Honduras In Costa Rica and Nicaragua, the real exchange rate was stable during the same period.

according to independent observers. When the present government assumed office in 1990, the decision not to privatize the BND was justified on the grounds that most of the lending resources of the economy were concentrated there, and also that the newly established private banks were too small and unwilling to offer financial services to a vast number of a customers. But the validity of this rationale, over the years, has become suspect, as the BND has aggressively moved to compete for customers that can be served by the private banks. In addition, this state bank enjoys preferential access on the rediscount credit lines that the Central Bank offers, allowing it to offer better loan terms to the public than its private competitors. Therefore, it is far from certain that the presence of the BND is one of an economically efficient unit in the service of the public good.

Despite the negative impact on the economy from the operation of the BND and two other state banks, no privatization activity is envisaged in Nicaragua this year. The same outlook holds for Honduras and Costa Rica. In Honduras, one state bank, BANADESA, controls, mercifully, just 5 percent of the loan market. This entity, for many years, was utilizing rediscount credit lines from the Central Bank as its own capital. In 1994, the Central Bank decided to suspend these lines, although the enormous debt remains unpaid. The danger now is that BANADESA will compete aggressively for deposits from the public, with the consequence that deposit rates may be pushed up substantially Higher deposit rates are needed in Honduras, but they should be offered by economically efficient and solvent financial entities. BANADESA, with arrears estimated at 65 percent of its loan portfolio in 1994, is not the appropriate candidate. In Costa Rica, privatization seems to be out of the question for political reasons. Three state banks dominate the market. together they hold approximately 60 percent of total assets and deposits. They have become hopelessly inefficient, with very high intermediation margins Of the state banks, Banco Nacional is in the worst shape, plagued by large arrears and by high operating costs.

Privatization is not an important issue in Belize, whose one public bank, the Development Finance Corporation, is a source of development loans and equity investment Privatization is also a minor issue in Panama, where there are three state banks of which the Banco Nacional de Panama holds 10 percent of total system assets. By the end of 1991, this bank was technically solvent, although over-branched and over-staffed [24] In Guatemala, the four state-owned banks are in dire financial shape. Fortunately, the

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[24] See de Vezin Olivier (1992).

weight of these banks on total assets and deposits is small and private banks are ten times as large[25] There are prospects for the liquidation of two of them in the upcoming months, the Agriculture Bank and the Housing Bank, which combined hold just 2 percent of total loan share of the system

3. Interest Rates

With the exception of Belize and some loan rates in Costa Rica, in the Central American region all deposit and loan rates are market-determined The use of market-driven rates is one of the most important changes that were introduced by the reforms that swept the financial landscape in the late 1980s and early 1990s. However, this change is not necessarily of tremendous significance for the health of financial systems of these countries The decision to allow for market determination of interest rates bears no positive impact when implemented in financial markets dominated by a handful of state or privately-owned banks that exhibit high operating costs As stated above, the presence of large state banks in Costa Rica and Nicaragua constitutes sources of important distortions. On the other hand, in Honduras, banking is largely concentrated in privately-owned entities which, for all practical purposes, operate by the rules of a bank cartel. When interest rates were liberalized in the late 1980s and early 1990s, the liberalization, in practice, was applied to the loan but not the deposit rates. This enabled banks to increase their intermediation margins substantially Guatemala presents another very interesting case In the late 1980s, interest rates were also liberalized, but the higher returns on overall investment that the government sought did not materialize: banks, which hold equity shares of many industrial concerns, refrained from raising loan rates to their most important customers, usually their own firms Since many of these firms stayed in business due to the shelter that excessive protection offered in the past, the banks' policy, in effect, constitutes an explicit subsidy that ultimately delays a badly needed process of industrial reconversion

4 Rediscount Facilities

Under ideal conditions, central banks should offer credit facilities for two purposes (1) as a lender of last resort to banks that confront liquidity problems, and (2) as an active trader in open market operations, trading government securities at market interest rates However, monetary control is compromised when central banks also offer rediscount

[25] Ibid

credit lines as tools to channel targeted and subsidized financing to selected activities

Guatemala, El Salvador and Costa Rica are countries where open market operations are used as active monetary policy. In Nicaragua, the Central Bank is reportedly trying to develop this policy It is not used at all in Panama (where there is no central bank) or Belize, while in Honduras it is largely ineffectual because a secondary market for the trading of government securities is undeveloped In Nicaragua and Honduras, rediscount facilities are still active policies In Nicaragua most, if not all, of these facilities are captured by the state banks with the purpose of directing credit to farming, industry and commerce, while in Honduras the privately-owned commercial banks are active users of these credit facilities There, strong evidence suggests that the rediscounts are used not to finance activities stipulated as preferred by the economic authorities (for example agriculture), but are channeled instead to other more profitable sectors Moreover, since their efforts to mobilize deposits is so weak, banks do rely on the availability of rediscount facilities as a source of funds Nevertheless, there is a positive indication that over recent years the volume of rediscount facilities has decreased in real terms

In El Salvador, rediscount facilities for targeted credit have declined in significance There are still some credit lines directed towards the financing of small agribusinesses and traditional agriculture A move towards less targeted credit or even its total elimination, as occurred in Guatemala, is expected in forthcoming years The reverse is happening in Costa Rica, as the present government contemplates the creation of a new development bank in order to channel subsidized credit to the benefit of microenterprises.

B. The Banking Sector

In general, banks in Central America are small, reflecting the size of the economies. Private, domestically-owned commercial banks dominate the market in El Salvador, Guatemala and Honduras, while in Costa Rica and Nicaragua, the state banks predominate Panama, an international banking center, is a magnet for foreign banks. In Belize, the banking sector plays a small role in the economy.

1 Structure of the Banking Sector

By far, the most developed banking sector in the region is that of

<u>El Salvador</u>. Seventeen private banks operate in this country, of which three capture 60 percent of all the deposits in the system. While seemingly evidence of concentration, this is offset by law which stipulates that no shareholder can hold more than 5 percent of equity shares of any bank. There are no visible restrictions to market entry for Salvadorans, while the severe restrictions on foreign bank operations that were implemented in 1981 are being rapidly phased out Foreign banks can open subsidiary offices to disburse loans, capture deposits, and trade in the foreign exchange market.

In El Salvador, banks were taken over by the State in the early 1980s, only to be reprivatized a decade later [26] The Salvadoran banks are the largest among the private banks of Central American countries, and some may even be larger than the state banks of Costa Rica. They are in good financial health and are very competitive, which is evidenced by low intermediation margins [27] The banks are expanding rapidly and are engaged in operations that offer trade finance, loan guarantees, credit cards and home mortgages There is one important caveat, however In the recent past, Salvadoran banks have engaged heavily in mortgage lending, especially in financing housing construction for the upper and middle classes. There is concern that too much credit may be concentrated in this sector.

In <u>Honduras</u>, the structure is very concentrated. There are twenty-four banks, but four of them dominate the market, with assets and deposits equivalent to over 65 percent of the total in the system. Two of these four banks belong to the same owner. This structure reflects underlying conditions of high concentration of wealth and incomes In this regard, the largest banks, which are owned by individuals with ties to powerful economic groups, effectively vie to provide financial services to just 90 clients In general, the banks operate with very high intermediation margins, on average

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[26]There is anecdotal evidence that points to lack of transparency in the privatization process in El Salvador Banks, allegedly, were sold off to entrepreneurs with strong ties with the government. It must be stated that cronyism and nepotism are features in the region and have not been eradicated by market reforms Even in a country as successful as Chile, the privatization process in the mid-1980s was criticized as being unfair and implemented with lack of transparency. The same criticism has been voiced with respect to the reprivatization of Mexican banks in the early 1990s In this country, independent observers claim that the process turned into a "sweetheart deal", one in which the owners, before the purchase, received loans from the banks that were later transferred to them These examples suggest that rent-seeking behavior and policies of exclusion die hard in the region, and that the road to more equitable development will be painfully slow.

[27]Mr. Kurt Focke, an Inter American Development Bank official, has estimated that the ratio of operating costs to total assets is 3 percent for major banks

above 9 percentage points, which is explained by the high reserve requirements and also by high operation costs.

The law does not establish barriers to entry, neither to Hondurans nor to foreigners. But the high concentration of wealth and the poor economic outlook constitute an effective deterrence for the entry of new participants in the market. In addition, the market is characterized by acute segmentation. In this regard, almost all banks have established their own *financieras* which operate as banks but with the advantage of escaping the high reserve requirements and supervision. It is highly plausible that the *financieras* intermediate a higher volume of financial resources than the banks Since the *financieras* are part of holdings which include other commercial and industrial concerns, they are vehicles to channel deposits from the public to the firms of the holding Banks can do likewise with impunity, given the lax supervision system.

In Nicaragua, of the nine private banks, two concentrate 40 percent of assets and deposits, excluding those in the hands of the state banks, which largely dominate the market. Nicaraguan private commercial banks were established following the demise of the Sandinista government in 1990 They are still very small and, as such, cannot engage in large scale lending. At present, intermediation margins are large, on average approximately 8 percentage points. These banks are not expanding aggressively and choose instead to concentrate their lending operations in foreign trade and commercial activities in urban areas Agriculture, the backbone of the Nicaraguan economy, is largely neglected by these banks However, there are good prospects that they may enter lending in the area of livestock.

Nicaragua has no barriers to entry for new banks. Banks can be established with a minimum capital of US$ 2 million But, like Honduras, the sorrowful state of the economy makes it unappealing to invest in banking

In Costa Rica, there are twenty-three private commercial banks, of which five largely concentrate the business which is not under the realm of the state banks These banks profit handsomely from the inefficiencies of state banks. Of the rest, many are too small and undercapitalized, which suggests that mergers are a distinct possibility in the future In order to be established, banks require twenty unrelated investors, each with no more than 5 percent of total equity Some observers point out that this is an effective barrier to entry, especially for foreign banks, since it is difficult to meet this requirement.

The market structure in Costa Rica is as segmented as in Honduras. This segmentation is attributed to high reserve requirements and also to a highly discriminatory regulatory framework. For example, leverage for private commercial banks is specified at 10:1, for *financieras* 7:1, and for state banks 30.1. The private banks are forbidden from accessing the rediscount facilities of the Central Bank. Only the state banks can have access to these facilities. In addition, sight deposits and checkbooks are offered only by the state banks. At present, however, a new law governing bank operations is being discussed and it is quite possible that private banks will be allowed to offer these services. In the meantime, the severe market segmentation caused by these policies has materialized in the proliferation of so-called offshore banking. Every bank in Costa Rica, including state-owned financial entities, has an offshore unit. These units mobilize more resources than the local banks and are not scrutinized by the supervisory entities. Although in the past the offshore units captured deposits in colones, presently they offer sight accounts only in dollars, on which they pay interest. The existence of these totally unregulated, unsupervised units also reflects the penchant of Costa Ricans to save abroad, the memories of a foreign exchange regime that until the early 1980s penalized dollar-denominated accounts and finally, the competition for Costa Rican customers from offshore units of Miami-based banks.

In Guatemala, there are 33 private commercial banks of which the top three hold one-third of all commercial banking assets. Reserve requirements are still high (17 percent), both on demand and time deposits, regardless of recent reductions. This explains the presence of an acute market segmentation, which was expressed until very recently in the existence of numerous informal lending entities. Largely unsupervised, these entities were effective competitors of formal banks but, at the same time, were prone to fraudulent behavior. For this reason, more stringent controls and capital adequacy requirements have been recently introduced. Though these measures alone are unlikely to eliminate market segmentation, the economic authorities are making other efforts. For example, the requirement of presidential approval to establish new banks has been eliminated.

Guatemalan banks are generally very inefficient, with large intermediation margins. Yet, in recent years, the banking sector has been expanding rapidly, which suggests that exogenous sources of funds, more concretely from illegal drug trade, fuel this boom. Another problem is that of concentration, which is evidenced by a handful of powerful economic groups which control the banks, and by substantial volumes of *préstamos relacionados*

Belize and Panama are countries where foreign banks dominate the market In Belize, in the early 1990s, the system consisted of only five foreign-owned commercial banks Panama is an international banking center with more than 120 banks of which most (80 percent) are foreign-owned. The majority of banks conduct both offshore and domestic banking Banks that conduct just offshore operations are barred from taking local deposits and from making local loans, the share of these offshore banks on total bank assets is approximately 25 percent The structure of the market is fairly competitive and there are no barriers to entry.

2. Some Important Features of the Banking Sector:

In five Central American countries -- Guatemala, El Salvador, Honduras, Nicaragua and Costa Rica -- the banking sector presents some important common characteristics These are the following:

(i) The financial instrument that has expanded most considerably is the credit card However, it is offered mainly to upper and middle class customers Small and medium sized entrepreneurs, whose access to formal credit is in practice denied, could potentially benefit from accessing credit cards because these are effective vehicles to substantially reduce transactions costs.

(ii) In general, with the exception of El Salvador, where 70 percent of loans have maturities of over one year, the average maturity of loans and deposits is short term. Long term loans with maturity of two to three years are offered very rarely, and only when the customer "kicks in" money and/or puts up solid guarantees With the exception of El Salvador, volatility of interest rates prevents the expansion of home mortgage loans.

(iii) It is not uncommon for banks to have tight ownership and/or business relations with other financial and non-financial entities With the exception of El Salvador and probably Nicaragua, systems are prone to excessive, unsupervised inside lending which pushes out small and medium sized businesses from the credit sector and which, ultimately, can endanger the safety of deposits.

(iv) In general, banks do not find it profitable to launch programs aimed at handling small size loans. Most of the lending is concentrated in urban areas

(v) Foreign trade is the preferred economic activity for banks Financing traditional exports is considered to be almost risk free Other preferred activities are commerce, construction and large businesses in urban areas

(vi) Legal systems are neither expedient nor reliable to order the execution of foreclosures in the event of non-repayment of loans.

(vii) Procedures to follow in case of bank insolvency are implemented arbitrarily and are politically influenced

(viii) Implicit deposit insurance from the central bank exists in Costa Rica and Nicaragua but only covers deposits placed in state banks. In Guatemala, the establishment of a private system of deposit insurance has just been approved, while it is still under consideration in El Salvador. In Honduras, as of April 1995, this issue was being discussed as part of a modernization law of financial systems.

(ix) Procedures for the disclosure of information on banks' health are more advanced in Guatemala, El Salvador and Nicaragua. In these countries, banks must publish their financial statements at least twice a year, while the supervisory entity must divulge information on risky assets and net worth for every bank. Information disclosure procedures are inadequate in Costa Rica and Honduras. With the exception of El Salvador, none of the regulatory frameworks obligates banks to publish information on arrears. In addition, internationally standard accounting principles are not consistently applied within countries The adoption of such standards is a critical first step to promote the regional harmonization of banking supervision [28]

(x) The development of the banking sector is constrained by weak efforts of savings mobilization. As a general rule,

[28] See de Vezin Olivier (1992) and also Camacho and González Vega (1994)

there is no culture of savings in the Central American countries Incomes are highly concentrated and the resulting social unrest does not encourage savings. In spite of the fact that in countries such as El Salvador and Honduras there is a vast network of bank branches in the countryside, rural savings are not mobilized at all because of widespread ignorance or because, as specifically evidenced in the case of Honduras, banks keep very low deposit rates. In addition, the savings effort was hampered by the process of political and economic deterioration that permeated the region in the 1980s

3 Bank Regulation and Quality of Supervision:

The adequacy of these systems varies by country. With respect to banking system regulation, El Salvador, Nicaragua, Guatemala and Costa Rica exhibit reasonable (Basel) capital adequacy standards. Honduras and Panama are exceptions Likewise, there is reasonable provision for bad loans in El Salvador, Guatemala, Costa Rica and Panama. Such is not the case, however, for Nicaragua and Honduras With respect to the entities in charge of commercial bank supervision, the following observations can be made [29]

(i) Quantity of personnel is reasonably good in Nicaragua, needs some upgrading in El Salvador, Costa Rica, Honduras and Belize, and needs major upgrading in Guatemala and Panama

(ii) Quality of personnel is satisfactory in Belize, while in El Salvador, Nicaragua and Costa Rica it needs some upgrading. Guatemala, Honduras and Panama still need major upgrading.

[29]The source of this evaluation is Westley (1995) He uses five criteria for evaluation. quantity of personnel, quality of personnel, salary levels, organization of the supervisory unit and freedom from political interference All these, with the exception of the organization of the supervisory unit are self explanatory Westley is not explicit in explaining what organization means, but we presume this refers to important attributes such as the overall quality of top management, ongoing personnel training programs and updated information systems

To these five criteria, Westley applies one of three "grades" reasonably good (adequate), needs some upgrading, and needs major upgrading (overhaul) In our discussion we have modified the "grading" of freedom of political interference and use instead three categories reasonably autonomous, mild interference and major interference

(iii) Salary levels are reasonably good in Costa Rica and Belize, whereas they need some upgrading in El Salvador and Nicaragua and substantial upgrading in Guatemala, Honduras and Panama

(iv) In terms of organization, the supervisory entity is reasonably good in El Salvador, Guatemala and Belize, but needs some upgrading in Nicaragua and Costa Rica. It needs major upgrading in Honduras and Panama.

(v) In terms of freedom from political interference, the supervisory entities are reasonably autonomous in Nicaragua, Guatemala, Belize and Panama. They suffer mild interference in El Salvador and Honduras [30] Major political interference occurs in Costa Rica.

C Capital Markets

The main instrument that is traded is government debt, either treasury bills or stabilization bonds from central banks. Generally, these instruments are short-term, with maturities that vary between 30 and 180 days. They are competitively priced in Guatemala, Costa Rica, Panama and El Salvador.

Commercial paper from private firms is also traded in some countries because of the tax-shield advantage that this instrument affords In Costa Rica, for example, private firms issue commercial paper that is sold at the Bolsa, on which they pay 29 percent, instead of the 49 percent that banks presently charge for loans. The advantage for the issuers is that the interest rate charges are tax deductible. With the proceeds of the issue, the firms can buy stabilization bonds from the Central Bank - which offer much higher yields and on which they pay just 8 percent tax.

Corporate equity and bonds are not developed in the region The most important reasons are as follows

(i) As a reflection of the high concentration of wealth and income that characterizes the region, the largest and most dynamic businesses in each country are family-owned and normally unwilling

[30] With regard to Honduras, we take issue with Westley's analysis We strongly believe that bank supervision in this country suffers from major political interference

to go public

(ii) Firms are also reluctant to go public because if they do, they would be forced to release information that they would otherwise not divulge This situation applies to firms which evade tax payments, apparently an important problem in most, if not all, countries of the region.

(iii) The long history of government-imposed easy and cheap credit gave firms an incentive to rely on bank borrowing and not on a wider equity base.

(iv) Corporate equity and bonds are not easily accepted by populations whose financial culture is very poor.

(v) Some countries, most notably Costa Rica and Honduras, suffer from volatility of interest rates At present, in Costa Rica, for example, interest rates on deposits are too high -- 33 percent while the inflation rate is 20 percent -- opening a convenient way for people to earn returns without purchasing equity

(vi) Since at least the late 1950s through the late 1980s, with the exception of Panama, the entire region long suffered from the expectations of currency devaluations [31]

(vii) Systems for the disclosure of information on the financial health of firms which could potentially trade stock are either nonexistent or untested

(viii) With the exception of El Salvador, regulatory frameworks must be improved to protect investors from fraud and insider lending They must also be broadened to give minority shareholders more rights In Costa Rica, for example, minority shareholders are not accepted on the boards of firms Similar restrictions exist in Guatemala and Honduras

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[31] This, of course, is not applicable to Panama. Neither would it be applicable in El Salvador, starting the second semester of 1996, if the government makes do on its recent promise of replacing as legal tender the colón by the dollar This announcement was greeted with approval by multinational lenders It is quite conceivable, therefore, that Salvadoran capital markets will experience rapid growth in the near future Whether this move will spur rapid and equitable growth in the real economy is another matter.

Finally, pension funds could provide a significant boost to capital markets, but not until they undergo a major overhaul In Costa Rica, the government forces the state-owned Caja Costarricense del Seguro Social and other private, specialized pension funds to buy government securities Guatemala presents a similar case the government prohibits the Instituto Guatemalteco de Seguridad Social (the country's largest pension fund) from investing in the securities market. Instead, funds from this entity as well as from lesser units are used to finance the fiscal deficit Similarly, bank deposits and government securities have been the main assets of Honduras's several pension funds In Panama, the range of investments from the wholly government-owned social security system and the small private pension funds is restricted as well. El Salvador's predominantly state-owned pension fund system is on the verge of undergoing a major transformation There is, in fact, a lively debate on the details of such a reconstruction, though widespread agreement about its necessity Meanwhile, Nicaragua has not yet developed pension funds.

D Summary

The reform process of financial markets in the Central American region is far from complete. The major constraint relates to the fragile macroeconomic situation in these countries. Costa Rica must bring its large fiscal deficit under control, whereas the economies of Honduras and Nicaragua are crucially dependent on help from foreign donors. Guatemala and El Salvador seem to be recovering, but the decision in El Salvador to adopt the dollar as legal tender, probably starting in mid-1996, raises concern While this decision will probably boost its capital markets, it offers no guarantees that faster economic development will follow.

By far, El Salvador exhibits the most advanced banking sector of the region, with the lowest intermediation margins. In Costa Rica, Honduras, Nicaragua, and Guatemala spreads still remain very high. State banks largely dominate the banking sector in Nicaragua and, to a lesser extent, in Costa Rica. These entities are thoroughly inefficient and the source of important distortions. In Nicaragua, the state banks have preferential access to rediscount lines from the Central Bank, while in Costa Rica, the private commercial banks benefit handsomely from their inefficiencies Yet, these countries have no plans for the liquidation or privatization

High reserve requirements in Honduras, Costa Rica and Guatemala explain the acute market segmentation that characterizes the banking sector in these countries A proliferation of informal financial entities (*financieras*) and offshore bank subsidiaries that escape regulation and supervision are the logical outgrowth These entities mobilize substantial resources On the other hand, banking in the entire region is highly concentrated in urban areas and in selected economic activities Concentration also applies to the beneficiaries of credit. In this regard, substantial volumes of so-called *préstamos relacionados* permeate banking operations in Honduras and Guatemala Though these operations probably face more efficient restrictions in the rest of the countries, it is not uncommon for banks' owners in the entire region to have interlocking businesses with other financial entities and even sometimes with non-financial concerns. Consequently, inside lending escapes detection. This fact dramatizes the urgency for adequate prudential norms and efficient bank supervision. To a high or low degree, all countries need to improve their bank supervisory systems

Finally, capital markets are poorly developed. The main instrument that is traded is government debt. Trading of corporate equity is almost unheard of due to the unwillingness of firms, mostly family-owned, to go public

II. The Andean Region

This section discusses the financial markets of the five Andean countries. Venezuela, Colombia, Ecuador, Peru and Bolivia. <u>Colombia</u> is characterized by a steady commitment to financial reform and stands out as one of the countries in the entire region where much has been achieved in the last ten years <u>Peru</u> has experienced a spectacular turnaround of its policy framework in a very short time Between 1991 and 1994, major reforms were introduced in this country, considered to offer the most liberal regime in financial markets <u>Bolivia</u> likewise offers a case of a country that has managed important reforms following long periods of pervasive government intervention in financial markets <u>Ecuador</u> has also been very effective in the implementation of financial reform, but, unlike Peru and Bolivia, the process has been slow Spared from the ravaging effects of hyperinflation that besieged Peru and Bolivia in the mid-eighties, Ecuador seldom felt the same urgency to move decisively in the direction of radical reform Although the comprehensive reforms enacted last year will probably result in a dramatic change of financial markets, this is not yet a certainty. In fact, a volatile political situation in this country has raised concerns about the sustainability of the reform process. Finally, <u>Venezuela</u> must be characterized as a tragedy. The country was shaken in early 1994 by a banking collapse that has resulted in losses equivalent to 16 percent of GDP The collapse occurred on the heels of one the most ambitious and comprehensive reforms ever undertaken by a Latin American country If anything, the Venezuelan crisis offers valuable lessons for other countries on the inherent dangers posed by hasty liberalization without adequate supervision, on the preeminence of private interests over the public good, and on the consequences from an unplanned, panic-ridden management of the crisis.

A. Policy Issues:

1. Macroeconomic Stability

Since the emergence of the banking crisis, the economic situation in Venezuela has gone from bad to worse The fiscal deficit has increased from 3 5 percent of GDP in 1993 to 7 percent in 1994 But if financial transfers from the Central Bank and the sky-high finance charges of the internal debt that prevailed until mid-1994 are included, this deficit could well surpass 16 percent The roots of the crisis can be traced, in general, to the painful shocks caused by a difficult transition from an economy dependent solely on oil revenue to a diversified one in which other productive sectors must survive competition in an open economy This transformation, initiated in the mid-eighties when it was clear that oil prices would not recover, and accelerated from 1989, was thwarted by deeper economic inequality and social strife The successive bloody coup attempts that rocked the country in 1992 and in 1993 are evidence of this Since then, the economy has been in a tailspin: in 1994, total output plummeted by 4 percent and inflation exceeded 70 percent

Unfortunately, no recovery is yet in sight. From a pre-banking crisis period of tight monetary policy that drove interest rates on deposits 40 percentage points above the inflation rate, the Central Bank has reversed course and injected too much liquidity in the system At the same time, the government has introduced foreign exchange and price controls. In combination with negative real deposit rates, this policy framework provides the recipe for Venezuelans to speculate on foreign exchange. In fact, illegal capital flight is rampant. With the economy mired in recession, the surviving banks find the purchase of government securities the only investment option, but even this is not terribly attractive because high inflation erodes the real returns of these instruments This unhealthy situation can be maintained as long as the government, which captures 85 percent of the oil revenues, has the wherewithal to finance the huge subsidies it has introduced to cushion the impact of the crisis on rich and poor alike Moreover, any decision to implement economic adjustment policies could bring, in the short term, very unwelcome consequences For example, an increase in real interest rates will definitely endanger the repayment capabilities of many borrowers which, in turn, would imperil the health of the surviving banks. With this in mind, another bank collapse is not an impossibility

Peru is the opposite of Venezuela GDP grew by 12.4 percent in 1994 and conservative estimates suggest that the rate of growth this year will reach approximately 10 percent. From a record high of 7,600 percent in 1990, inflation dropped to 17.5 percent in 1994 and may well fall to below 10 percent this year, a level last achieved in the early 1960s. In addition, for the first time in over three decades, the country posted a substantial surplus in its fiscal account in 1994, a phenomenon attributable in large part to the extraordinary revenues generated from the sell-off of state-owned concerns The fiscal stimulus furnished by those revenues has been the catalyst of an economic dynamism that will make Peru the fastest growing economy in the region again this year. However, there are two important caveats that must not be ignored The first is that the current fiscal expansion would not be cause for alarm if the Peruvian treasury had the capacity to continue to generate equivalent revenues in the future Unfortunately, this does not seem to be case, since, were it not for privatization, all indications suggest that the fiscal account would be negative. Indeed, tax revenues as a percentage of GDP still hover around 14 percent, a proportion far too low to continue to finance the ambitious public programs undertaken since the second half of 1993 If tax revenues do not increase, at some point Peru will have no choice other than painful fiscal adjustment.

The second problem lies in a fragile external sector. The trade deficit more than doubled from 1993 to 1994, while the current account deficit now stands at 5.6 percent of GDP. This is very high by any standard and especially dangerous in the wake of the devaluation of the Mexican peso The magnitude of these deficits also suggests that the sol is overvalued. In fact, notwithstanding the 17.5 percent inflation rate, the nominal exchange rate basically remained unchanged in 1994 Considering that a real overvaluation of 30 percent had been calculated for the period 1990-1993, there are grounds for legitimate concern on the evolution of the external accounts Most worrisome is the fact that exports have performed poorly In this regard, the 1994 value of exports, in nominal terms, barely surpassed that of 1980 while, in per capita terms, it approximated the value reached in 1950.

In the past, the standard response to balance-of-payments disequilibria has consisted of sharp reductions of public and private expenditures and steep depreciations of the sol, which in turn have triggered lower output, falling incomes, and higher inflation. Should one or more of Peru's current sources of external financing dry up in the near future, the Central Bank has adequate foreign exchange at its disposal to head off a major balance-of-payments crisis for a couple of years. In the longer term, however, the situation suggests the possibility of a crisis of great proportions -- especially if the country continues to fail to expand exports significantly.

After suffering from hyperinflation in the early to mid-eighties, Bolivia has enjoyed two successive years of single-digit inflation In terms of output growth, Bolivia has not performed as spectacularly as Peru, and the economy exhibits similar, if not deeper, macroeconomic fragilities The fiscal deficit jumped to 6.4 percent of GDP in 1993. In 1994, it fell to 4 5 percent, but its financing is still very dependent on the availability of foreign aid.[32] Most worrisome is the fact that the current account deficit is very high, approximately 10.5 percent of GDP by the end of 1994. In all, Bolivia's economy is the weakest among this group, vulnerable to the vagaries of foreign aid and to adverse changes in the prices of international commodities On the other hand, the macroeconomic situation showed marked improvements in Ecuador. In 1994, an inflation rate of 25 percent was registered, which compares very favorably with rates that oscillated between 50 and 60 percent in the period 1989-1992 The fiscal deficit was 0.5 percent of GDP in 1994 which is entirely consistent with macroeconomic stability Importantly, this has been achieved at little cost to economic activity (GDP grew by 4 percent in 1994) But there are two issues that cloud the macroeconomic outlook in Ecuador The first is that the improvements in inflation could have been engineered by the eight percent revaluation of the sucre in 1994, which underlines a dangerous trend in the period 1990-1994, the real exchange rate applicable to Ecuadorean exports appreciated by 22 4 percent. The second issue relates to the unfortunate border war that was waged against Peru early in 1995. Since this conflict is far from resolved, it is reasonable to suggest that further gains for 1995 in inflation and in the fiscal deficit will be all but impossible

Finally, Colombia has had a strong reputation of macroeconomic

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[32]Of the 6 4 percent of GDP that the fiscal deficit measured in 1993, 5 4 percent was covered by external financing and 1.0 percent was accounted for by internal financing (See World Bank, 1994a) Although no figures are yet available for 1994, it is reasonable to assume that the external sources were the main source of financing the 1994 fiscal deficit, in view of the fact that the government has yet to implement profound fiscal reforms

stability since the early 1960s Fiscal deficits, as a rule, have been always kept in check and financed in non-inflationary ways There is a problem, though, relating to the difficulty in keeping monetary aggregates in target For instance, in the last eight years, inflation has oscillated between 22 and 32 percent per year. This problem is intimately related to the fact that the country absorbs massive inflows of foreign exchange which, when monetized in pesos, help to sustain strong growth of domestic demand. Short-term capital inflows as well as proceeds from illegal exports are two very important sources of such inflows in Colombia A related problem is that of currency appreciation, which has been a constant in the Colombian economy since at least the early to mid-1970s More recently, in the period 1990-1994, the real exchange rate applicable to Colombian exports appreciated by 23 7 percent Not surprisingly, the economic authorities have continually resorted to sterilization, in the form of open market operations and increases in reserve requirements on bank deposits, as an instrument to exercise better control of monetary aggregates [33]

2. Privatization·

The banking collapse in Venezuela forced the government to take over eleven banks At present, close to 50 percent of total assets of the banking system are under state control Given the volatile political situation, the severity of the economic crisis, and the palpable lack of interest from domestic and private investors, there is no chance that those entities will be reprivatized anytime soon Costly restructuring and clean-up processes must be undertaken first. In addition, the government is sensitive to the fact that any future resale of all or some of the banks will be scrutinized closely by a disenchanted public.

The record of Peru is quite impressive By the end of 1994, a total of 40 percent of the total loan portfolio held by state banks had been

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[33]Sterilization, though, is very costly Reserve requirements on demand deposits are very high, at 41 percent This measure, in combination with open market operations (exchange of central bank bonds for foreign exchange), sends interest rates skyward. Indeed, in 1994, deposit rates in Colombia reached 13 percent in real terms Ultimately, this is self-defeating because the high interest rates, in turn, attract more short term capital inflows There are two additional problems. One is the fact that sterilization normally carries quasi-fiscal costs, which, in Colombia, reached 0 8 percent of GDP in 1991. The second is that the high real interest rates choke growth in the real economy. For these reasons, in the last two years Colombia has been trying to rely less on sterilization and more on other measures, specifically, the imposition of controls, taxes and other impediments to capital inflows, on one hand, and the elimination of restrictions on capital outflows, on the other (See Schadler, *et al*, 1993).

either privatized or liquidated, including four state development banks that were hopelessly decapitalized The trend has continued in earnest in 1995 with the successful divestiture of one of the largest banks in the country, Banco Continental, which was purchased by Spain's Banco Bilbao Vizcaya in early May. The sell-off of Banco Mercantil is expected in the near future. In addition, two Chilean-owned banks opened in early 1994. These events are of great significance, for the privatization of those state banks had been resisted by powerful domestic banking concerns who saw new entrants, specifically foreigners, as a direct threat to their shares of the market Bolivia also managed to close state-owned banks in the period 1989-1991, including Banco Agrícola de Bolivia (BAB), Banco Minero (BAMIN) and Fondo Nacional de Exploración Minera (FONEM), the three of which held 19 percent of the system's bank assets, 25 percent of all bank branches, and 19 percent of all staff employed by the banking sector. Privatization, consequently, is no longer an issue in this country, since what is pending is just the final liquidation and clean up of these concerns

The case of Ecuador, however, is different There are no prospects in the near future for the privatization of the three state-owned banks, the Corporación Financiera Nacional (a second tier bank), the Banco Nacional de Fomento (the state agricultural bank) and the Banco Ecuatoriano de la Vivienda (a mortgage bank), which together hold 20 percent of the banking system loan market Generally, these entities are not managed properly, which is reflected in their high operation costs and in the poor quality of their portfolios The Banco Nacional de Fomento is particularly inefficient It has traditionally allocated loans at below-market interest rates, largely to the benefit of privileged borrowers. It has also been very unsuccessful in attracting deposits, as rates paid on their savings instruments have been consistently below those offered by commercial banks and savings and loan associations Last but not least, loan recoveries have fallen dramatically in recent years Not surprisingly, this entity has been forced to rely on external sources of funds for lending, namely the Central Bank and loans from the IDB and The World Bank [34]

In Colombia, there is an ongoing process of privatization of financial concerns which dates back to 1991 Entities that have been privatized or liquidated include Banco de Colombia, Banco de los Trabajadores, Banco Tequendama, Banco de Comercio, Corporación Financiera de Desarrollo,

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[34]In the period 1981-1988, foreign loans from these multilateral financial entities increased from 2 percent to over 20 percent of total source of funds In recent years, however, loans from these donors have diminished significantly

Corporación de Ahorro y Vivienda Popular, Banco Cafetero and Banco del Estado There are four remaining publicly-owned financial entities -- Instituto de Fomento Industrial (industrial development bank), Banco Central Hipotecario (mortgage bank), Caja Agraria (agricultural bank) and Banco Popular (a bank which provides financial services to small clients) -- which together hold eighteen percent of total assets of the banking system. Of these, the Banco Central Hipotecario and Banco Popular may be privatized soon. Neither the Instituto de Fomento Industrial, which has recently benefited from recent loans for restructuring from The World Bank, nor the Caja Agraria, which according to government plans will be recapitalized, are in the privatization scheme. Caja Agraria represents close to 10 percent of total assets of commercial banks Its major inefficiencies include high operating costs, massive loan reschedulings, and a politically-determined allocation of funds This bank is not solvent at all, and introduces distortions in the financial system [35]

3. Interest Rates, Reserve Requirements and Targeted Credit

In <u>Peru</u> and <u>Bolivia</u>, commercial bank interest rates on loans and deposits are market-determined In <u>Ecuador</u>, the Monetary Board still exercises power to set interest rates on loans and deposits It must be stressed, however, that as opposed to the practices of the 1980s, the Monetary Board, in recent months, has been allowing financial entities to adjust their rates in closer accordance to prevailing market conditions. In <u>Colombia</u>, deposit rates were liberalized in the 1980s, while some commercial bank interest rates, most notably those on loans from state banks, are set by the government In <u>Venezuela</u>, there has been a complete reversal of the previous liberalization of interest rates, as a result of the banking collapse. At present, the government sets both the loan and deposit rates, which are negative in real terms.

Local currency reserve requirements on bank demand and time deposits have been lowered to 9 percent in <u>Peru</u> Those on foreign currency time deposits have been reduced from 51 to 42 percent Although this is still very high, the government is reluctant to reduce these reserves further. It

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[35] In 1993, the government forced the Caja Agraria to reschedule its large overdue portfolio and to extend subsidized loans to its clientele While this measure impinges into the financial health of the entity, it also does little to uphold the credit culture of a large clientele to the highest standards. In addition, the last restructuring plan contemplated the decision to have the Caja Agraria compete aggressively to capture deposits. The consequence could well be, as in the case of Argentina's provincial banks, to push deposit rates way up.

fears that additional short term capital inflows and the ensuing appreciation of the already overvalued sol would bring unwelcome consequences. Far from signaling renewed investor confidence, the inflows of short term capital in recent years have been a direct consequence of tight domestic credit policies that have been in effect since August 1990 Another consequence has been dollarization. at least two thirds of total system deposits and loans are effected in dollars, which ultimately reflects a continuing distrust in sol-denominated financial instruments. As regards targeted credit, all programs have been eliminated with the exception of one aimed at providing credit to farmers This program, though, is small and is not channeled through the financial system [36]

The financial system of Bolivia is also highly dollarized -- as much as 90 percent of banks' assets and liabilities is made up of dollar accounts -- but foreign currency reserve requirements on time deposits are comparatively low, at just 10 percent Reserves requirement on local currency demand and time deposits are also very low, 10 and 4 percent respectively [37] Reserve requirements, consequently, are not critically important instruments of monetary policy. More often, monetary policy relies on open market operations, primarily by way of trading of short term Central Bank certificates of deposits, most of which are denominated in dollars or indexed to the greenback. However, the efficient conduct of monetary policy is compromised by the existence of numerous targeted credit lines which are offered by foreign donors -- the IDB, USAID, and the Corporación Andina de Fomento (CAF), among others -- and administered by the Central Bank. This is but another expression of how foreign assistance exerts influence on the Bolivian economy.

Neither Colombia nor Ecuador exhibit dollarized financial systems In Colombia, as stated above, local currency reserve requirements on demand deposits are very high, at 41 percent, but those on time deposits for both local and foreign currency are low 2 percent for local currency deposits above six months, 1 percent for those above 12 months, and 5 percent for all those in foreign currency The intention to increase substantially the

[36] This is called FONDEAGROS and was established to fill the vacuum left by the demise of Banco Agrario, the old state agricultural bank FONDEAGROS is run by the Ministry of Agriculture and is financed by revenues from agricultural import surcharges The program is tainted by political patronage and has a poor record of loan collection In fact, it has been estimated that as much as 50 percent of its loan portfolio is overdue.

[37] No reserve requirements are imposed for time deposits with maturity dates of over 12 months

volumes of credit lines that are targeted for agriculture does not bode well for the future More than sound economics, this decision reflects the political imperatives of the moment, for Colombian agriculture has suffered from low international prices, natural disasters, and also increased subversive activities

In Ecuador, on the other hand, local currency reserve requirements on demand and time deposits were reduced significantly last year, from 25 to 10 percent Those for foreign currency time deposits have been also set at 10 percent. As a result of this action, it is expected that intermediation margins will be reduced considerably. There is a strong commitment to abandon reserve requirements in favor of open market operations as the key instrument of monetary policy Targeted credit lines are only in effect for the state-owned banks and they are expected to be reduced further in the near future

Finally, in Venezuela, targeted credit lines are offered for housing and agriculture. The volumes are not large. Reserve requirements on demand and time deposits are 12 percent. No dollar-denominated deposits are formally allowed. Nevertheless, the severity of the crisis has signaled an incipient and steady process of dollarization A proposal by Steve Hanke to introduce a *Caja de Conversión* which will make the dollar the legal tender (similar to that announced in El Salvador), is reportedly in advanced stages of discussion among policy makers [38]

B The Banking Sector

With the exception of Venezuela, and to a lesser extent, Bolivia, the banking sector of the Andean countries appears to be more solvent than in the 1980s. It is rapidly becoming more competitive in Ecuador, while Peru and Colombia are moving more slowly

1 Structure of the Banking Sector

In Peru, there are twenty private commercial banks in operation Some banks -- most notably Banco de Crédito and Banco Wiese -- are performing extremely well. However, these two banks now hold 51 percent of all deposits, up from 32 percent in 1990, which suggests that substantial market

[38]This suggestion reflects despair and, if introduced, the predominance of political expediency at the expense of sound economics *praxis* It defies reason to consider the viability of such a proposal in a country that presents severe economic distortions and financial imbalances.

concentration has taken place. Other banks are saddled with high proportions of loans of doubtful recovery, and most banks have high unit operating costs Typically, banks deal with this problem by raising loan rates This is a feasible option due to both the oligopolistic structure of the market and the high floor that international lenders -- ever sensitive to perceived country risk -- impose on domestic rates. The bottom line is that sol-denominated interest rates continue to be very high, and act as a deterrent to domestic investment.

Peruvian margins of intermediation are among the highest in the region On average, the financial margin is 10 percentage points, explained by high loan-loss provisions and high payroll costs High financial margins, however, are not sustainable, as foreign banks no longer face barriers to enter the market. In this regard, Spain's largest financial entity, Banco Santander, is reportedly closing negotiations for the acquisition of the privately held shares of Banco Mercantil Obviously, foreign entities enjoy the benefits of unimpeded access to funds from their home offices and other banks abroad, of highly efficient, computerized systems, and fewer low-quality portfolios It remains to be seen if, armed with these advantages, the entrance of foreign entities will threaten the existence of the domestic banking system, or instead force it to be more competitive

Market expansion is constrained by a relatively large deficient loan portfolio. As a percentage of total outstanding loans, average arrears have been declining steadily, from 8.4 percent in March 1994, to 7 25 percent in December 1994, to 6.37 percent in March 1995 Yet, in comparison with international standards, this is still very high Poverty in rural areas, the existence of many provinces under state of emergency and insignificant agricultural lending are also factors that deter market expansion Provision of credit to the agricultural sector, in particular, is hampered by the fact that of the 5,022 *comunidades campesinas*[39] that are officially recognized, only 1,004 are titled Nevertheless, there is evidence that banks have been more aggressive recently in seeking new clientele For example, there is a rush to offer consumer loans to middle-to-low income groups that dwell in urban areas Traditionally, informal lenders or credit unions served the demand for financial services from these groups. Similarly, there is evidence that banks are studying ways to enter the market of microenterprise lending. In this regard, Banco Wiese has recently launched a special program with the purpose of handling small size loans to rural dwellers north of Lima

[39] This term refers to production units modeled after the *ayllu*, the type of social organization that prevailed during the Inca period

In Bolivia, there are nine domestic banks and four foreign banks in operation. Of these, two banks are clearly the leaders, each holding at least 15 percent of all system deposits The market's oligopolistic structure will likely be strengthened by the probable liquidation or merger of four banks Given the small size of the domestic market, it seems inevitable that the country's banking system will remain concentrated.

Not surprisingly, the leading banks are not interested in expanding the supply of financial services such as trade finance, home mortgage and credit cards. They are by-and-large satisfied with the exorbitant returns from existing operations. As a rule, banks operate with high operating costs and intermediation margins which are even higher than in Peru. To spur competition, the country could conceivably waive selected foreign banks from the minimal capital requirement and allow them to establish branches all over the country. However, local banks would probably oppose this option on grounds of discrimination.[40]

Apparently, Bolivian commercial banks are not interested in expanding operations to the benefit of marginalized clienteles either Here lies a large, potentially profitable market One recently established financial entity, Banco Sol, is currently testing an interesting experiment, which resembles the *modus operandi* of Bank Rakyat Indonesia, perhaps the leading bank worldwide for providing financial services to marginalized customers dwelling in rural areas Banco Sol is regulated by special legislation and is being hailed as a success Nevertheless, its administrative costs are believed to be high due to the fact that its operations are labor intensive In addition, Banco Sol does not rediscount its loans with the private commercial banks based in La Paz. Failure to do so underlines the acute segmentation of markets that characterizes the Bolivian financial sector.

Overall, the financial health of Bolivia's banking system is currently very fragile While total bank capital more than doubled between 1990 and 1993, liabilities rose even faster. Return to equity decreased from 12 percent in early 1991 to 2 percent in early 1994. Experts from multilateral banks are convinced that several banks present potential problems of illiquidity and/or insolvency. Supervisory agencies are reluctant to act against these entities, knowing that any change in the *status quo* could cause half of the system to collapse.

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[40]This discussion greatly benefited from the input of Vicente Fretes-Cilbis, World Bank country economist for Bolivia.

In Ecuador, the banking sector is dominated by powerful economic groups. There are more than twenty private commercial banks of which seven concentrate more than half of the assets not just of the banking system but of the entire financial sector as well. Moreover, the leading banks have ownership ties with other financial entities and relate operationally with them.

The banking sector in Ecuador is rapidly evolving into an open and competitive system. The government, though, is actively encouraging those who would set up new banks to capitalize existing banks instead This is a sound measure, for increasing the number of banks may not be economically wise, given the small size of the domestic market. On the other hand, notwithstanding the impressive gains obtained since the enactment in early 1994 of the new banking law, the market is still severely segmented. This, without any doubt, is a legacy of the policy framework of the 1980s [41] In addition, the system is permeated by abnormally high intermediation margins, over 10 percent annually

Not unlike Bolivia, private commercial banks in Ecuador have yet to tap the market of small and medium size customers This lack of interest, in combination with the appalling inefficiencies of the Banco Nacional de Fomento (BNF), has opened opportunities for private investors who are succeeding in providing specialized financial services to the marginalized clientele One such example is FINAGRO, a private entity founded by 33 Ecuadorean private investors. In late 1992, the Inter American Investment Corporation of the IDB provided additional equity. FINAGRO serves traders and small farmers in the area of Babahoyo, a rich agricultural region in southern Ecuador. In fact, the company even out-competes the BNF. While the state bank offers substantially lower loan rates, its loan procedures are plagued by vast inefficiencies that result in prohibitively high transactions costs for customers. FINAGRO faces little competition from the informal lenders who operate in the area, since its loan rates are lower and it can provide technical assistance to small farmers as well.

In Colombia, the banking system has now recovered from the severe

[41]In that decade, the main features of financial repression prevailed in Ecuador. In no other country of the region was this problem as acute. For example, reserve requirements were used ineffectively and erratically, no interest was paid on these reserves, and private lenders faced higher levels of reserve requirements than the public banks Furthermore, private banks were penalized by the mandatory purchases of securities at face value, with negative yields in real terms Last, but not least, policies included heavily subsidized and explicitly discriminatory lending

crisis of the mid-1980s. Most of the banks that were taken over by the State in that period have already been sold back to the private sector. At present there are 27 commercial banks, 23 financial corporations, 10 savings and loan entities, 31 commercial financing companies and 2 special credit agencies -- the Caja Agraria and the Banco Central Hipotecario. Foreign participation in the banking sector was highly restricted until 1990, when most stipulations were eliminated. Since 1987, the sector has been profitable, due to the rapid expansion of credit as well as due to large spreads

Not unlike Ecuador, a high degree of financial repression existed in Colombia until the mid-1980s.[42] Although major reforms have been enacted, reserve requirements must be reduced further in order to induce faster growth in the system

In <u>Venezuela</u>, the banking sector was competitive before the crisis. Now it is heavily concentrated, with two dominant banks, Banco Provincial and Banco Mercantil The financial health of both of these entities is suspect Intermediation margins are very high, averaging approximately 10 percent There are no barriers to entry and both domestic and foreign banks enjoy equal rights and treatment. However, market entry bears little significance in an economy so paralyzed that banking is unappealing to domestic and foreign investors alike.

Amid this catastrophic situation, there is nonetheless one positive sign Banco Mercantil offers extensive credit lines for microentrepreneurs in urban and rural areas These loans are offered at the highest rate -- 47 percent -- that authorities approve. With an inflation rate of 70 percent per year, however, this rate is negative in real terms

2. Some Important Features of the Banking Sector

The following features of the Andean region are worth noting

(i) <u>Peruvian</u> banks find trade financing to be most profitable. In <u>Ecuador</u>, the credit card is the product with the fastest growth rate and loan guarantees are also well developed In <u>Bolivia</u>, banks do offer trade financing, credit cards and loan guarantees, but the scope of these services is very limited <u>Colombian</u> banks and the surviving

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[42] See McKinnon (1991)

entities in Venezuela provide these services nationwide.

(ii) For all practical purposes, home mortgages are shunned by private commercial banks in all the countries of this region.

(iii) No significant long-term financing is provided because deposits are basically short-term. Average maturities of loans are very short: 60 days in Bolivia, and 90 days in Peru, Ecuador and Venezuela.

(iv) Colombia is more advanced than the other Andean countries with regard to the capacity to attract long-term foreign loans from private sources. In Peru, there is limited access to long-term loans from foreign banks because the country-risk factor is high.[43]

(v) Banks operate as multipurpose banks in Peru, Ecuador, Venezuela, Colombia and Bolivia In Peru, some restrictions apply to investments in non-financial concerns. No such legal restrictions are applied in Ecuador and Venezuela

(vi) In case of non-repayment of loans, legal systems are expedient to order the execution of foreclosures in all of these countries The problems lies in the judiciary. In Bolivia, it is slow and unpredictable. In Venezuela, Ecuador and, to a lesser extent in Peru, the process is tainted by corruption.

(vii) In case of bank insolvency, sound procedures are stipulated by law in Peru, Ecuador, Bolivia and Colombia. But these procedures, especially in Bolivia, are not enforced. In Venezuela, the system is tainted by arbitrariness, as demonstrated by the case-by-case approach that was followed during the crisis

(viii) There are no legal constraints that impede local

[43] This is due to the fact that Peru's debt with foreign private commercial banks has been in arrears since 1984 At the moment, though, the economic authorities are negotiating a Brady Plan which will probably be concluded before the end of the year. Once this agreement is signed, the country-risk factor should be reduced significantly.

savings mobilization by banks in this region. The problem is that, as a rule, banks offer just a handful of savings instruments, all of them invariably with short-term maturities (normally no more than six months) In _Bolivia_, where expectations on future developments in the Argentine economy play a large role, and _Venezuela_, the maturities are even shorter In all the countries but Venezuela the deposit rates are positive in real terms In 1994, there was an influx of foreign savings in _Colombia_ and _Ecuador_ due to very high deposit rates

(ix) In _Venezuela_, savings mobilization is also constrained by inflation Financial resources flow to real assets and to the dollar. Lack of trust is another critical impediment To a lesser degree, this factor is also present in _Bolivia_. In this country, savings is also hampered by the high explicit transactions costs of banks As a rule, banks charge hefty fees for checking accounts and certificates of deposits.

(x) In _Peru_, _Bolivia_ and _Ecuador_ there is persuasive evidence that large numbers of people, especially those dwelling in rural areas and in the periphery of big cities, do save but in the form of non-financial assets. To convert this into financial savings will take time because, more than the construction of branch facilities, these countries need better information networks. In addition, educational systems must be improved to raise the level of financial awareness of the disadvantaged sectors

3. Bank Regulation and Quality of Supervision:

Banks in _Colombia_, _Peru_ and _Ecuador_ currently exhibit Basel capital adequacy standards as well as reasonable provisioning for bad loans In _Bolivia_, the law stipulates that banks abide by these norms, but they are not enforced in practice _Venezuela_ does not even have these standards in place

Supervision, in the past, has been lax in Peru Just two years ago, an unsupervised *financiera*, CLAE, collapsed The estimated losses borne by depositors totaled US$ 400 million With technical assistance from the IDB, the supervisory capacity in this country is being upgraded, however, supervision does not yet extend to informal financial entities. This is also source of concern in Bolivia, where not even cooperatives are supervised adequately

With regard to the entities in charge of commercial bank supervision, Westley (1995) notes:

> (i) Quantity of personnel is reasonably good in Bolivia. Some upgrading is needed in Colombia, Peru and Ecuador, and it needs major improvement in Venezuela
>
> (ii) In Colombia and Bolivia quality of personnel is reasonably good It needs some upgrading in Peru and needs major upgrading in Ecuador and Venezuela.
>
> (iii) Salary levels are reasonably good in Colombia and Ecuador. By the beginning of 1995, salary levels were too low in Venezuela but recent information indicates that the budget has been increased for the superintendency In Bolivia salary levels need some upgrading, while in Peru an unusual development is taking place for the first time in almost thirty years, the superintendency is attracting capable professionals from the best, foreign-owned accounting firms This suggests that salary levels are very competitive in this country.
>
> (iv) In terms of organization, the supervisory units of Peru and Bolivia are reasonably good Colombia and Ecuador need some upgrading Venezuela's supervisory units need a major overhaul.
>
> (v) In terms of freedom from political interference, all supervisory units in these countries, with the exception of Venezuela, are reasonably autonomous

C Capital Markets

Equity is the most traded instrument in Peru. In spite of a decline attributed to the Mexican crisis and to raising interest rates in the United States, Lima is still the most profitable stock market in the region and one of the most attractive of the world's emerging markets Until late 1994, daily trading averaged one thousand transactions for a total value of

US$ 8 million per day An estimated 70 percent of daily transactions involve foreign capital. Overall return on capital in 1992 was 138 percent, one of the highest in the world. Experts believe that prospects for future growth are good: the stock market exchange is worth only some 10 percent of GDP, suggesting great potential for development (witness Chile, where total stock market capitalization is equivalent to 80 percent of GDP) The market faces a problem of concentration: of the approximately 250 companies authorized to operate, ten account for 80 percent of volumes transacted.

Bonds and commercial paper are also traded in the Lima Stock Exchange, but not government securities. The private pension funds, launched in mid-1993, have the potential to provide a significant boost to the stock market. So far, however, most of their investments are materialized in the purchase of the Central Bank's certificate of deposits and time deposits in leading financial entities, not in the acquisition of shares of top firms Managers of these funds complain that the regulations on investment are too restrictive [44]

Unlike Peru, government bonds are the main instruments in the capital markets of Ecuador The market is very small in this country. Private equity is traded very little, if at all, in large part because most businesses are family-owned. There are other hurdles as well, in particular, a tax on capital gains. This tax, in combination with the memories of the times of cheap and easy credit, tilt the preferences of firms in favor of debt. Another deterrent is that the minimum capital requirement to be a stock broker is too high

There are no private pension funds in Ecuador, and the government-run social security system is not financially viable At present, however, there are discussions aimed at overhauling the entire system, with two options under consideration: either the complete privatization of the pension funds system, or one that combines public and private funds

In Bolivia, capital markets are very small. Government securities and Central Bank certificates of deposits are traded, but trading is very weak As in Ecuador, private equity is not traded because firms are family-owned The skewed income distribution also constrains the growth of the

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[44]They and other spokespersons of the private pension funds also complained that the government has not been lending sufficient support to the development of the industry For example, by the end of 1994, the government had not authorized the issue of social security certificates, which would have facilitated the transfer of employees' state pension funds to the private system

capital market. Furthermore, wealthy people hold more assets abroad than inside the country

A regulatory and legal framework is in the process of being drafted It is unlikely that this will provide a noticeable boost to the market without significant economic development taking place first New legislation regulating private pension funds is unlikely to fuel more trading either, since the low proportion of workers who are formally employed (15 percent) limits the size of the system.

In Venezuela, the capital markets were badly shaken by the banking crisis In fairness, the problem was brewing long before the crisis erupted, and the bloody coup attempts that rocked the political scene in 1992 and 1993 increased the country risk dramatically The collapse of the eleven banks made matters far worse because they, through the ownership of brokerage houses and investment banks, were powerful players in the stock market

Venezuela has undergone a real reversal of fortune. Before the crisis, the country would place US$ 800 million worth of Eurobonds in a single year Now, this window is closed both for public and private placements All that remains are 60 to 90 day maturity private commercial paper and government securities Banks do buy the stabilization bonds that the Central Bank sells to sterilize liquidity, because the only alternatives are to hold cash or place funds in the Central Bank -- where they earn no return Overall, however, there is little domestic activity because of capital flight Private pension funds are non-existent in the country, and there no concrete plans to establish a system in the near future, thus eliminating this potential vehicle of support.

Venezuela lacks the basic pre-conditions for the development of capital markets The Comisión Nacional de Valores (the equivalent of the Securities and Exchange Commission in the United States) is inefficient and poorly staffed Also, the over-regulated economic environment scares investors away In addition, the long history in this country of cheap bank financing, which provided firms incentives to rely on bank credit instead of capital markets, remains influential. With respect to private equity in particular, the poor outlook will remain so as long as a handful of family-owned firms control the stock market Indeed, in the pre-crisis period, one of the greatest impediments was precisely the public's suspicion that a handful of players speculated, dominated, and manipulated the market to their advantage

In Colombia, a new capital markets law was introduced in 1993 Very recently, the country approved the listing of and disclosure requirements for the foreign companies that operate in its domestic market In addition, the Colombian authorities signed an information sharing agreement with Venezuela.[45] Relative to the size of the economy, the capital market is well developed, and almost all financial instruments are traded Since 1991, the market has been growing very fast, both in terms of total market capitalization and volume of daily trading. There is concern, however, that competition is restricted. At present, a task force with technical support from The World Bank is undertaking a study to review this issue. On the other hand, the recently reformed pension funds system may provide a boost to the market.

Other characteristics of capital markets in this region that are worth highlighting are the following

(i) The legal and regulatory frameworks in Ecuador, Peru and Colombia protect investors against fraud and insider trading. However, these three countries, especially Peru, still face problems of enforcement [46] In Bolivia, a supervisory agency will be established once the draft of the legal and regulatory frameworks is finished and approved In Venezuela, investors are not protected at all, not even on paper

(ii) The systems for disclosure of information on the financial health of corporations which trade stock seem to be reliable and comprehensive in Ecuador, Peru and Colombia. The problem, however, is that they do not reach a wide audience. These systems are nonexistent in Bolivia and Venezuela.

(iii) Colombia's market is far ahead of those in the other countries in the provision and development of mechanisms for risk reduction

[45] United States Treasury (1995).

[46] There is anecdotal evidence that in Peru one of the top financiers of the world was "taken for a ride" last year

D. Summary

Financial markets in this region contend with the presence of important macroeconomic constraints Venezuela, one of the largest economies in the Hemisphere, is enduring its most severe crisis in decades The fiscal deficit is too high and inflation is repressed by subsidies and price controls of doubtful efficacy. These measures are not conducive to rapid recovery The unstable economic and political situation threatens to unravel another banking collapse. Colombia, in sharp contrast to Venezuela, has enjoyed economic stability since at least the 1960s. This country has been blessed by consistent application of sound fiscal policies but still faces the problems of how to keep inflation under control and how to contain the tendency for currency overvaluation Peru has engineered a remarkable turnaround but, like Colombia, it suffers from severe currency overvaluation. The greatest challenge in this country is to maintain fiscal discipline in the upcoming years, especially when the revenues from privatization of state companies cease. The macroeconomic situation in Ecuador is slowly improving, but in Bolivia, the poorest country of the region and the most dependent on foreign donors, it will take years to achieve sustained economic development

Colombia, Bolivia and Peru have made great strides with respect to the privatization of state banks Ecuador is moving very slowly, if at all, whereas the sell-off of banks is unthinkable in Venezuela at this time High intermediation margins characterize banking operations in this region These are bound to be reduced in Peru, Ecuador and Colombia, where new entrants will hopefully introduce more competition. In Bolivia, where half of the banks are probably insolvent, the government has yet to recognize this issue

In general, the average maturities of both loans and deposits are short term in the entire region, and these services are, in practice, denied to the vast marginalized clientele of Peru, Bolivia and Ecuador. Regarding supervision, all countries need some degree of technical assistance In Venezuela, a major overhaul of the supervisory agency is a matter of utmost urgency.

The regulatory frameworks that govern capital markets have been modernized only in Ecuador, Colombia and Peru, but enforcement of regulations that protect investors is problematic, especially in Peru Trading of all financial instruments is expected to keep growing in Colombia and probably less rapidly in Peru, where the market is dominated by foreign participants In Venezuela, the market suffered a debacle because the collapsed banks were active players in it and no recovery is still distant Finally, very slow growth is expected in Ecuador and Bolivia, since their economies are still small and characterized by heavy concentration of incomes

III. Mercosur

This section discusses Chile, Argentina, Brazil, Paraguay and Uruguay. Chile[47] has been widely recognized as the star performer of the Hemisphere. Following a catastrophic bank collapse in 1982, it introduced far-reaching reforms in the mid-1980s As a consequence, the country exhibits the highest domestic savings ratio in the region. Its solid banking sector thrives from the positive effects of a fast-growing economy. In addition, capital markets are dynamic and expanding rapidly Argentina's future is still uncertain The impressive macroeconomic reforms introduced in 1991 launched the country on a path of spectacular economic growth, only to be halted in the aftermath of the collapse of the Mexican economy Greatly constrained by low domestic savings and by dwindling private capital inflows, the economic authorities have subscribed to tough austerity measures that guarantee severe deflation in the months ahead. Clearly, this will cause difficulties in the banking sector in the upcoming months. Brazil also faces uncertainty, revolving around its political situation more than its economy. The critical question in this country is whether the president -- an avowed modernizer -- can muster the political will and obtain approval from Congress to launch economic and financial reforms that are long overdue. For many years, inflation has been an intractable problem, due to the inability to reach political consensus on the need to reform and downsize the public sector Finally, Paraguay and Uruguay are countries that exhibit the classical characteristics of "buffer" states, with economies that cannot rival the two South American giants in either size or importance Paraguay is economically dependent on Brazil, whereas Uruguay, since the late 1980s, is purportedly evolving into a "fiscal paradise" that will attract, in time, increasing volumes of financial and economic transactions from Brazilian and Argentine investors.

[47] Chile is included in this group for matters of convenience Formally, this country is not member of Mercosur, for two reasons. First, Chile's tariff is lower than the common external tariff that the Mercosur countries have adopted. Second, Chile's foreign trade strategy strongly relies on efforts to diversify and penetrate all markets. In this regard, while the Mercosur countries have agreed to negotiate the free trade expansion for the Americas as a group, Chile is already negotiating with the United States, Mexico and Canada its entry into NAFTA.

A. Policy Issues

1. Macroeconomic Stability:

Fiscal discipline and a pragmatic approach to monetary policy have characterized the economic stability of Chile for many years. At least since 1985, the economic authorities have run sizeable budget surpluses. With respect to monetary policy, the authorities abide by a central objective to keep the exchange rate competitive. For this reason, the peso is allowed to float in a wide band around a central rate that the authorities try to hold constant in real terms. As a consequence, bringing down inflation to single digits took longer than in countries that used a fixed exchange rate as an instrument to tame hyperinflation (such as Mexico and Argentina). The strategy has clearly paid off, today, Chile boasts very low inflation rates by Latin American standards and spectacular economic growth performance [48]

Ironically, Chile is now paying a price for this success. The country attracts too much foreign capital, imperiling the competitiveness of the real exchange rate. Yet, the Chilean economic authorities have proven to be deft at handling this problem First, they have stimulated long-term foreign direct investment, which has increased ten-fold since 1986. But they have not been as enthusiastic with respect to portfolio investment. In this regard, strict regulations are applied to the issuance of foreign bonds and American Depository Receipts (ADRs) by Chilean companies, while foreign equity investment must stay in the country for at least a year. In addition, a 30 percent reserve requirement is applied to foreign currency time deposits The objective of these measures, clearly, has been to discourage "fly-by-night" capital. The events that rocked financial markets in Mexico and Argentina have underscored the Chilean authorities' prescience.

At present, the challenge lies in finding an alternative to the costs from too much sterilization of capital inflows. In effect, the Central Bank is actively engaged in placing bonds that are marketed with very attractive yields This results in losses, since the interest rate that the Central Bank pays on these bonds is higher than what it gets from its assets These losses are now substantial, approximately US$ 1,500 million estimated for 1995, and equivalent to 3 percent of GDP.

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[48] In the period 1991-1994, GDP grew by 28 percent in real terms, second in the Hemisphere only to Argentina. In 1994, inflation was 8.9 percent, down from 18.7 percent in 1991. In 1995, inflation will be even lower, while the economy is projected to grow even more rapidly.

Argentina was the country most negatively affected by the Mexican crisis. Its most serious manifestation was a spectacular run on bank deposits. As a result, the monetary base shrank The Central Bank stepped in to soften the deflationary blow by offering banks rediscount lines, by lowering the reserve requirements and, significantly, by not enforcing reserve requirements to many banks. If the monetary authorities had not acted promptly, the crisis would have taken catastrophic dimensions, as activities in the real economy would have severely contracted. If anything, the crisis served to expose the fragility of the banking sector, on the whole highly inefficient, concentrated, and with scant capacity to assess risks

Following the reelection of President Menem last May, there are signs of improvement Recently released financial statistics indicate that a third of the deposits that were withdrawn early in the year have now returned to the system, but these are concentrated in a handful of banks. The problem, however, is that bank lending has become quite restrictive, as loans go primarily to selected customers This is, in part, symptomatic of the current recession. It will be mild if the economic authorities can ensure a real depreciation of the peso. But this is normally more difficult with a system of fixed nominal exchange rates.[49] Therefore, the burden falls on varying nominal prices to ensure rapid shifts in favor of the production of tradeables. This requires the removal of all restrictions that limit downward price flexibility of labor, capital and public utilities, as well as measures aimed at enhancing total factor productivity Given that the positive effects from such actions take time to materialize, the economic authorities' only action now is to apply stern fiscal measures to ensure the contraction of aggregate demand that the logic of economic adjustment requires.[50]

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[49]In 1991, Argentina approved the Convertibility Plan which basically bars the Central Bank from pursuing an "active" monetary policy. The plan mandates an eighty percent foreign currency backing for each peso in circulation, with the remaining twenty percent backed by government securities Before the crisis, the foreign currency backing was above 115 percent, whereas now it has reached the eighty percent limit.

In practical terms, the Convertibility Plan transfers the responsibility for the stability of the peso to other central banks A modernized version of the gold standard, it has acted as a "straightjacket," prohibiting the government from printing money to finance fiscal deficits In addition, since the implementation of the Plan, the country has benefited from substantial capital inflows due to renewed investor confidence The drawback of the plan is the legacy of an overvalued currency that has penalized investment in tradeables while increasing economic vulnerability in times when the capital inflows dry up

[50]In the end, the success of the Argentine strategy will depend on enormous fiscal discipline. By this criteria, the country's achievements thus far have been quite impressive. whereas in the 1980s, fiscal deficits on average reached

The Research Department of Banco Francés has optimistically estimated that Argentina's GDP will fall by one percent in 1995. However, the fiscal surplus target that was accorded with the IMF early in the year will not be met, so that more fiscal contraction will be necessary Equally important is the fact that the fall of nominal prices, to the extent that this occurs, is slow and not generalized. One important reason lies in the presence of wage rigidities in professions such as law, medicine and education In some tradeable sectors where nominal prices may be falling, such as the automobile and electrodomestics industries, higher production for exports is not materializing because these industries do not compete well in world markets. The opportunity that recent economic reforms offered for the modernization of these industries was, unfortunately, overlooked. To a large extent, the high cost of capital that firms have faced throughout the entire period of economic reform explains this missed chance.

High inflation has been the chief problem in <u>Brazil</u>'s economy for the last forty years. Since 1987, inflation rates have been no less than 400 percent and they reached as high as 2,500 percent in 1993. In order to ameliorate the effects on financial intermediation, a vast, complex system of price indexation applied to financial services was adopted in the early 1960s.[51] Reducing inflation to single digit levels will be not easy, for the Brazilian Constitution enshrines the obligation of the federal government to dispense tax revenues to the states Moreover, these funds are not always spent for good purposes. One of the biggest recipients of federal funds, for example, are the state banks, which function more often as instruments of patronage of the state governments than as entities-for-development.

In July 1994, following an inflation rate of almost 50 percent during the preceding month, the government announced a stabilization plan that was based on significant fiscal contraction and on the introduction of a new

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9 percent of GDP, in the period 1991-1994 healthy fiscal <u>surpluses</u> were obtained

It must be emphasized, however, that the successful process of privatization during the period 1990-1994 facilitated the enforcement of fiscal discipline. At present, the State still has assets to sell but overall revenues will be significantly lower Therefore, the burden will fall on higher taxes and lower expenditures. The magnitude of the fiscal adjustment will have to be big, given the low domestic savings and the difficulties of finding foreign buyers of public debt The combination of all these factors, unfortunately, signals the unfolding of severe social unrest. In this regard, recent events in Cordoba, the third largest province of the country and an important industrial center, are foreboding In this province, public employees have revolted, in protest for three months of unpaid salaries.

[51]It was abolished in early July of this year

currency, the real. The initial results were impressive, as the monthly inflation rate fell to 2 percent in December 1994. But this was achieved at the expense of an overvaluation of the real In fact, the substantial surpluses in the trade balance were rapidly reversed in the months that followed the introduction of the plan. Cognizant of the large current account deficits that triggered the Mexican crisis, the Brazilian authorities have opted to enact periodic devaluations of the real. But this decision has created nervous tensions among Brazil's partners in Mercosur, especially Argentina, whose chances for recovery are tightly tied to its capacity to export to the Brazilian market.[52]

Unlike Argentina, past indexation and the recent appreciation of the real prevent the dollarization of the Brazilian economy. Long-term financial contracts, however, are effected in dollars. Of more pressing concern is the Central Bank's activity in open market operations, with the sale of government securities that offer competitive yields. Performed on a grand scale, this results in strong upward pressure on interest rates, which ultimately crowds out the private sector.

Inflation in Paraguay was 19 percent in 1994 Efforts to reduce it to single digit levels are hampered by the purchase of dollars by the Central Bank and by the indexation of key prices in the economy. In Uruguay, inflation was higher, 44 percent, also explained by the indexation mechanism Fiscal deficits in both countries are not significantly large and are financed in non-inflationary ways. In addition, the appreciation of the local currencies, the guaraní and the peso respectively, plays a role in holding inflation down In Paraguay, there is a trend towards dollarization of the economy but it has not reached the depth of Uruguay, where 75 percent of all bank deposits and loans are transacted in dollars

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[52]The importance of the Brazilian market to Argentine exports is enormous According to the Research Department of Argentina's Banco Francés, half of the total increase of Argentine exports that have been registered in the first months of this year (1995) come from higher sales to Brazil, fundamentally explained by the fact that the real appreciated by 12.6 percent with respect to the Argentine peso. The nominal devaluation of the real will not be a problem for Argentina as long as it does not surpass 25 percent a year, which would only occur if the stabilization plan in Brazil collapses. Although analysts believe that this scenario is unlikely, the overall situation negatively affects plans for long-term investment. This lends credence to the fact that Mercosur will not firmly establish itself as long as the main partners do not properly coordinate their monetary policies

2. Privatization

Chile has one remaining state bank, the Banco del Estado, which has existed for 145 years and has functioned as a consolidated state bank since 1953 During the Pinochet Administration (1973-1990), the bank was a candidate for privatization. Allegedly, during the period of anticipated privatization, the bank went into a dormant period in which it implemented no new programs or mechanical modernizations Since 1991, it has returned to its role as the financial development tool for the Chilean government and, consequently, is not expected to be privatized With this renewed emphasis, the bank is cautiously entering programs to lend to smaller-scale farmers and more marginalized clients. It recently modernized and implemented automated systems for managing savings and credit accounts, and has the potential for reaching a vast clientele due to its network of branches throughout the country, including extremely remote areas.[53]

In Argentina, The World Bank is actively engaged in an ambitious program that calls for the privatization or liquidation of the provincial banks. The program demands the transfer of at least 51 percent of equity and the appointment of new managers. The process is proceeding reasonably well, although two of the largest provincial banks, the Banco de la Provincia de Buenos Aires and the Banco de Cordoba, which together account for 11 percent of total banking system assets, are not expected to go into the privatization block Given the fact that the Central Bank has stopped financing them, some provincial banks are reportedly capturing deposits from the public and/or enjoying financial support from the provincial governments However, unlimited financial support from provincial government was a viable option only until 1994 Now, the federal government is intent upon forcing those governments to implement tough austerity plans.[54] Therefore, if a provincial government decides to support its provincial bank, it must either raise local

[53]The bank has deep roots in servicing the Chilean private sector, but unlike the experience of other state banks in the region, it benefits from competent managers who nurture a very solid and conservative portfolio. In addition, this state bank has made impressive strides with savings mobilization In fact, Banco del Estado has managed to capture 70 percent of Chile's savings, or 7,000 out of 13,000 total savings accounts in the country. The bank targets customers not considered profitable by other commercial financial entities.

[54]Until 1994, each province, on average, obtained 64 percent of its total financial resources either from revenues collected nationally or from loans or transfers from the federal government. In some provinces this measure even reached 90 percent. This meant a lack of correspondence between provincial expenditures and their ability to collect local revenues. Not surprisingly, public expenditures in some provinces rose by 60 percent in nominal terms in the period 1992-1994.

revenues or curtail local expenditures. This is precisely the root of the problem in Cordoba, where the decision to keep the provincial bank afloat has been made at the expense of the salaries of public employees

Two of the largest banks in Brazil, the Bank of Brazil, which is the financial agent of the Treasury, and the National Bank for Economic Development, are likely to remain in state hands for years to come. In addition, recent developments indicate that the poorly run *bancos estaduales*, the equivalent of the Argentine provincial banks, may not be privatized or liquidated anytime soon. In general, these banks are not properly supervised and the Central Bank is forced to cover their losses by renewing rediscount facilities In Paraguay, out of thirty-four banks, six are state-owned and control 30 percent of the banking system loan market. One of these, the Banco Nacional de Agricultura e Industria, is the largest bank in the country. None of these six will be privatized anytime soon Finally, in Uruguay, two large state banks, the Banco de la República Oriental del Uruguay (BROU) and the Banco Hipotecario del Uruguay (BHU), a mortgage bank, concentrate 40 percent of total assets of the banking system. The BROU is three times as large as the BHU. Both of these banks are highly inefficient, their spreads are very large, and they offer credit only in pesos [55] Traditionally, these banks have enjoyed special privileges, such as waivers from reserve requirements on their deposits, but recent measures demand that they abide by the same reserve requirements as the private banks At present, the government has no plans to privatize or liquidate these two state banks However, the government is moving ahead with the final liquidation of the last bank (the Caja Obrera) which it intervened as a result of the banking crisis of the early 1980s

3 Interest Rates, Reserve Requirements and Targeted Credit.

In Chile, all deposit rates have been market-determined since 1985. Loan rates are subject to ceilings based on the average deposit rate. Deposit rates are also market-determined in Argentina, but there are ceilings on some loan rates. In Brazil, the recent elimination of indexation has paved the way for the market determination of both deposit and loan rates In Paraguay and Uruguay, both deposit and loan rates are freely determined by

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[55] Currently, however, these two banks are reportedly making profits This is because they capture deposits in dollars and make loans in pesos The loan rate, incidentally, is tied to the minimum wage, which lately has been rising This, in combination with the appreciation of the peso, largely explains the profits Still, any gains must be recognized as temporary, since a depreciation of the peso will probably reverse this trend. This insight was offered by Ernesto Feldman of the International Monetary Fund.

market forces

Reserve requirements in Chile for demand and time deposits in local currency are 9 and 4 percent respectively, whereas those for foreign currency are 30 percent In Argentina, reserve requirements, although they have been coming down, are still very high 33 percent on demand deposits and 3 percent on time deposits These reserves are not remunerated and bankers contend that they largely explain the high spreads that permeate the banking industry. This view is highly controversial, for some empirical studies demonstrate that the marginal contribution of reserve requirements to spreads is just one-tenth of one percent.[56] In any event, the economic authorities believe that the high level of reserve requirements is entirely justified because Argentine banks have normally been undercapitalized, and also because the Convertibility Plan bars the Central Bank from acting as a lender of last resort In Brazil, reserve requirements are even higher: 90 percent on demand deposits, which are not remunerated, and 30 percent on time deposits. Clearly, these key instruments of the anti-inflationary stabilization plan are unlikely to be lowered as long as the fiscal situation remains fragile. One big problem in this country is that the authorities change reserve requirements too frequently Often, reserve requirements are raised to induce increases in interest rates. Another problem, as stated in Chapter One, is that they vary by state, by type of financial entity and by type of deposit In Paraguay, reserve requirements for both local and foreign currency demand and time deposits are high -- 30 percent -- but they have come down in recent months and there are plans to reduce them further in the near future Finally, in Uruguay, they are not high 10 percent for demand and time deposits in local currency,[57] and 10 percent on foreign currency denominated deposits with maturities by less than 30 days, but 4 percent on those with maturities beyond 180 days.

Regarding targeted credit, Chile's Banco del Estado offers special programs for housing. These, as well as other programs for the benefit of small miners (offered by another state entity), are gradually being reduced. Not so, however, for the special programs administered by INDAP, a government agency in charge of providing technology transfer and credit to small farmers

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[56]One of these studies was conducted by Sergio Galván, former Central Bank employee and currently the head of the Research Unit of Sud Inversiones & Análisis, a Buenos Aires based consulting firm Mr Galván believes that the large spreads are explained by high fixed costs and by the poor quality of loan portfolios.

[57]This rate refers to those deposits which mature in less than 30 days; it is 2 percent for those with maturities beyond 180 days

with 12 hectares or fewer of non-irrigated land. These farmers are considered to be marginalized and outside of available commercial credit. Normally, INDAP offers credit at subsidized rates and its main role is to organize and select the rural income families willing to participate in the program In Argentina, Brazil and Paraguay targeted credit lines have been declining steadily over the years. What remains are small programs that are devised to finance agricultural activities Uruguay, on the other hand, offers no such programs

B The Banking Sector.

Chile and Brazil exhibit banking systems that are generally modern, dynamic, and highly competitive. Given the size of its economy, the banking system in Argentina is backwards, highly concentrated and plagued by glaring inefficiencies In Paraguay, banks are small and inefficient, whereas the private banks in Uruguay, not unlike those in Costa Rica, greatly benefit from the inefficiencies of the state banks.

1 Structure of the Banking Sector:

In Chile, there are thirty-three banks, of which nineteen are foreign, thirteen are locally-owned and one, the Banco del Estado, is state-owned By December 1994, the local banks had 834 branches and employed 23,149 people, the network of Banco del Estado included 214 branches nationwide with a total payroll staff of 8,728, and the foreign banks had 177 branches with a total of 4,888 employees. Both the number of branches and total employment have been gradually increasing since December 1990 [58] Overall, the sector seems to be profitable, with high quality assets In effect, the percentage of arrears on total banking system portfolio was 1 02 percent by December 1994 In this regard, the local banks have the best percentage (0 74 percent) against 0 80 percent of foreign banks and 2 77 percent of Banco del Estado

The turnaround of the Chilean banking system is all the more remarkable given the systemic collapse that occurred in 1982 [59] A

[58] By then, local banks had 550 branches and employed 20,756 employees, the numbers for Banco del Estado and the foreign banks were 182 and 8,124; and 146 and 4,117 respectively Source: Superintendencia de Bancos e Instituciones Financieras de Chile

[59] Among the several factors that explain this collapse, it is worth emphasizing three (1) there was no scrutiny of the "new" bankers who entered the market in the mid-1970s, mostly, the new entrants were buyers of state banks and made their bids with loans granted by the state, (2) supervisory agencies

comprehensive, well-designed bail-out program was implemented It was costly though, as the Central Bank covered the deposits and purchased the overdue loans from the banks To finance the rescue, the Central Bank issued debt notes which yielded 7 percent in real terms. Once the banks were reprivatized, they bought debt instruments from the Central Bank with real term yields above 7 percent In combination with a cheaper exchange rate offered to private debtors to pay their foreign debts, this amounted to losses that the Central Bank had to assume, equivalent to 2 percent of GDP for several years.

Entry of new banks must be approved by the Superintendencia de Bancos e Instituciones Financieras This entity issues licences every time a person or a corporation wants to purchase at least 10 percent of the equity of a bank. New approval or licences have not been granted since 1988, perhaps a sign that there are effective barriers to entry. On the other hand, high officials in the Superintendencia believe that the entry of new banks cannot be justified, given the size of the market. They believe that the trend in the market is the opposite, expecting the merger of existing banks.[60]

Chilean banks offer a wide array of financial services, such as trade finance, credit cards, home mortgages, loan guarantees, and so forth. In the leading banks, the quality of these services is reportedly very good and offered with low spreads All banks are allowed to operate as multipurpose banking, so that they can undertake every type of financial operation -- including factoring, leasing, insurance, brokerage, and investment banking They can undertake these operations either through the banks themselves or through affiliates There is a ceiling corresponding to 5 percent of total capital on the maximum amount of credit that can be granted to an individual. In case of credits granted to groups that own the bank, the limit is one-time capital plus the reserves for the entire group. As regards deposit insurance, there is a small state guarantee program, which only applies to individuals and not to corporations The guarantee covers 90

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made no adequate assessment of quality of loan portfolios; and (3) substantial volumes of credit were destined to the so-called *grupos relacionados*, i.e , inside loans.

By way of comparison, these three factors were also behind the severe crisis that unfolded in Venezuela and Mexico in 1994 and 1995, respectively It is remarkable that the painful, widely-known Chilean lessons, well disseminated by the media and by academic studies, were ignored by policy makers in these two countries

[60]Two of the largest local banks, Banco de Santiago and Banco O'Higgins, are reportedly negotiating a merger

percent of the obligations of the financial system with depositors, for a maximum of US$ 3,000 per individual.

In general, Chilean private commercial banks do not find it profitable to handle small size loans. One important exception, Banco de Desarrollo, provides financial services to small-scale, marginalized producers not targeted by other private commercial banks Funded by the Catholic Church as a development finance company in 1983, it has evolved to function not as a development project, but as a for-profit business that services the marginalized clientele. A venture capital with a foreign bank has allowed expansion from eight to 34 branches. Programs include the promotion of microenterprise development in agriculture. Loan rates are higher than commercial banks and Banco del Estado, reflecting built-in transactions costs and spreads Yet, Banco de Desarrollo is reportedly far more adaptable, less rigid in requirements, and faster in loan processing and disbursement than Banco del Estado Not unlike this entity, Banco de Desarrollo also provides savings services and technical assistance to its customers.

Argentina has approximately 135 banks, but just twenty of them concentrate eighty percent of all assets and deposits Early in the year, there were 170 but some thirty-five have folded or have been intervened following the run on deposits that deeply affected the entire system. The World Bank is financing a program that calls for the consolidation of the private commercial banks through mergers or liquidation Most of these are small, inefficient and family-owned, and are not even registered in the stock exchange They concentrate just 15 percent of all deposits and have managed to stay in business largely because they benefit from the inefficiencies of the provincial banks [61] Unlike the privatization of the provincial banks, the process of consolidation of these private banks is occurring very slowly. One of the impediments is that prospective buyers (the larger banks) find sale prices to be too high. Another deterrent lies in the fact that the Central Bank has not shown decisiveness in forcing mergers, nor the willingness to intervene the entities for their eventual resale - probably because this operation would entail losses that the State would ultimately have to absorb

Experts believe that the size of the Argentine market does not warrant more than 40 or 45 banks. The issue, however, is not the consolidation of the system into fewer units, but how to ensure that the

[61] This resembles the conditions of profitability of the Costa Rican private banks that have been discussed before. Private banks in Uruguay, as discussed below, face a similar situation as well.

resulting market is more dynamic and competitive Even before the crisis, the system was characterized by very large spreads and loan rates that were prohibitively high in real terms. This could only be sustained by an oligopolistic market structure and by the predominance of a bank cartel that exercised influence in the design of the regulatory framework, thus ensuring the insulation of market niches to the benefit of the larger units. This structure basically determined the poor development of the system, expressed not only in sluggish deposit mobilization but also in poor services to customers.[62]

In fairness, the memories of high inflation, combined with past confiscation of deposits and high country risk, stand in the way of increasing financial deepening to the level that exists in Chile. The greatest challenge in the country is precisely to increase the low volume of financial intermediation with substantially reduced spreads.[63] Deposits have very short maturities, normally from one to three months Not surprisingly, loans are also offered with very short maturities The most important banks offer most financial services but, as noted above, at very high interest rates. As long as this situation prevails, the Argentine economy will not expand, suppressed by the rent-seeking activities of its banking system.

One bank, Banco de Galicia, has reportedly opened credit lines for medium sized businesses. In general, though, small farmers cannot access financial services from the private commercial banks. Normally, the provincial banks have served this niche. How the privatization or liquidation of these banks will affect small farmers is uncertain Hopefully, the bank credit records will not be lost and thus facilitate good customers' entry to the market.

The gradual improvement of the supervisory functions is a significant development considering that in the 1980s Argentine banks had no

[62]For example, to carry a checkbook is more a cost than a benefit for customers Banks charge hefty fees for the checking accounts of customers

[63]This, naturally, is the goal in the long run In the immediate future however, the country can only look towards bank survival The present recession increases banks' vulnerability, deteriorating the quality of their portfolios. Serious problems of illiquidity or insolvency could force the Central Bank to rescue entities, but this would endanger the Convertibility Plan If this falters, and results in a devaluation, banks will greatly suffer because they have captured deposits in dollars and pesos but given out peso loans "*con mantenimiento de valor*", i.e. with values indexed to the dollar The entire scenario, the reader should note, could evolve into a major systemic crisis

supervisory mechanism. Capital requirements are now 11.5 percent and even higher for banks with abnormally high lending rates Unfortunately, procedures in case of bank insolvency are ineffectual Lastly, a system of deposit guarantee has been introduced recently It covers deposits for a maximum of US$ 20,000, but there is zero coverage if the yields on deposits are above 12 percent

Brazil counts approximately 260 banks, of which 30 are fairly large. The system is somewhat competitive, although three banks clearly stand out Multipurpose banks are the most important financial entities, but investment banks and entities that operate solely as commercial banks also play a big role in the financial system. Since 1988, there have been no entry restrictions for domestic banks. On the other hand, entry for foreign banks has been highly restricted since the 1930s This restriction takes the form of limits to ownership (foreigners cannot own more than 50 percent of equity) and to voting rights (foreigners cannot hold more than one-third of voting rights) Nevertheless, a proposed constitutional amendment promises a good chance that these restrictions will be eliminated soon.

Commercial banks offer all types of financial services with the exception of home mortgages This product is not well developed because mortgage loans do not adjust for inflation as rapidly as deposits. In general all loans are short term, with average maturities of 30 days, reflecting the widely-felt presence of high inflation as well as the bad experiences with indexation The short maturities negatively affect firms in the real economy, which are forced to finance expansion plans with loans from the state banks, from retained earnings and from foreign sources

Banks operate in multipurpose banking through holdings. Prudential norms are adequate to prevent excessive concentration of lending within the holding, but they do not restrict lending by criteria of geographic concentration or type of economic activity. Furthermore, the prudential norms apply only to the financial activities of the holding; the Central Bank does not look into their non-financial activities because it does not have the capacity to exercise proper supervision of these activities Procedures in case of bank insolvency are effective, when applied, to private banks [64] The state banks, not surprisingly, are invariably exempt from such procedures

Banks in Brazil face the constraint that the public, in general,

[64] On occasion, the government has intervened to force the Central Bank to inject liquidity into troubled private commercial banks

is unwilling to save long-term. The average maturity of time deposits is just thirty days. This, of course, is one of the legacies of so many years of high inflation. With regard to the legal and judiciary systems, banks, in general, do not contend with major difficulties Since enforcement of guarantees is fast, banks are not necessarily forced to factor in a premium on loan rates for presumed delays and poor enforcement of foreclosures.

Of the thirty-four banks in Paraguay, 21 are local and 13 are foreign There are no restrictions on the ownership of these entities, but the locally-owned banks belong to major economic "groups" of the country. There is also freedom of entry and no discrimination between domestic and foreign banks At least three new banks were established in 1994.

Consumer loans make up the majority of credit. Both trade finance and home mortgages are relatively non-existent In addition, banks do not find it profitable to handle small loans In general, all loans are very short term, with a maximum maturity of 180 days. Deposits are also very short-term In the past, deposit mobilization was constrained by low deposit rates, but this has changed now with the liberalization of interest rates. Experts believe, however, that most Paraguayans save offshore, mostly in Uruguay, the Cayman Islands, Panama and Miami.

There is no multipurpose banking in Paraguay. Inadequate prudential norms and supervisory functions pose a major problem. At present, there are no minimum capital requirements for the establishment of new banks, although the government is reportedly on the eve of announcing a Basel-type regulatory framework The particularly weak superintendency cannot enforce regulations against inside lending. Audits of private commercial banks are a rarity, and simply non-existent in the case of state banks. Moreover, banks are not required to divulge information to the public

Paraguayan banks face an inadequate legal system It can take months or years to foreclose on a property. In addition, the judiciary is weak and enforcement is almost totally lacking Lastly, there are no established procedures in case of bank insolvency, for which the superintendency has no legal basis to intervene anyway.

In Uruguay, the banking system is made up of the two large state banks and twenty other commercial banks, all of which are foreign-owned Peso-denominated financial transactions are mainly the domain of the state banks, which concentrate the bulk of their credit on mortgages and agriculture The private commercial banks concentrate mostly in dollar-denominated services and operate under a framework that has all of the characteristics of offshore banking Unlike Argentina and Brazil, there has never been confiscation of deposits in Uruguay, a fact that serves to explain the confidence that local and foreign depositors have in the system The private banks capture more than half of total domestic savings, but they take substantial volumes of deposits from abroad as well It is worth mentioning, in this regard, that in the aftermath of the collapse of the Mexican peso, Uruguay was the only country in the region that sustained capital inflows, primarily from Argentina and Brazil.

True to the spirit of offshore banking, the private banks can lend anywhere and to anyone, on average at very short-term maturities Yet, unlike current practices of the state banks, private banks do not lend to local borrowers in pesos from dollar-denominated deposits. This was not the case in the years that preceded the crisis of 1982, when many banks went under as a result of large borrower defaults that followed currency devaluation. Currently, foreign deposits are re-routed abroad.

The banks offer all types of conventional financial products -- trade finance, credit cards, loan guarantees, and so forth -- but the supply of these services could potentially expand. Three factors impede the realization of this potential. The first is high inflation and overall macroeconomic instability. The second comes from the reality that banks are not very dynamic, apparently comfortable with their present profit margins This is related to the fact that the private banks clearly benefit from the inefficiencies of the state banks The two state-owned entities offer very low rates on peso-denominated deposits, while they charge high rates on peso-denominated loans This underlines the presence of very large spreads. The private banks benefit because these spreads enable them to capture rents from the relatively few peso-denominated operations they control, which ultimately serves to bolster the slim margins they obtain from the dollar-denominated transactions.

The third and final factor lies in the serious institutional constraints that banks face For example, labor unions have a strong and pervasive influence on the entire banking industry According to Uruguayan labor laws, banks are prohibited from laying off employees Another problem relates to complicated procedures to recover debts in arrears The government, true to the well-entrenched tradition of the welfare state in vogue in the country since the 1920s, does its best to prevent firms from going under It normally demands that banks refinance loans to the benefit of troubled borrowers

2 Bank Regulation and Quality of Supervision

As noted above, capital adequacy standards have been significantly raised in Argentina, where they are even more rigorous than Basel standards Although Paraguay's standards lie at the other extreme, this problem should be corrected soon. Banking systems in Chile, Brazil and Uruguay abide by reasonable capital adequacy standards. As regards requirements for the provisioning of bad loans, they are reasonably good in Chile, Uruguay and Brazil, but improvements are needed in Argentina and Paraguay.

With respect of the quality of supervisory entities, according to Westley (1995):

(i) Quantity of personnel is reasonably adequate in Uruguay, Chile and Paraguay, while it needs some upgrading in Brazil and Argentina

(ii) With respect to the quality of personnel, it is reasonably adequate in Uruguay and Chile, it needs some upgrading in Argentina, and it needs a major overhaul in Brazil and Paraguay.

(iii) Wages are competitive with private sector salaries in Uruguay, Chile, Paraguay and Brazil, but not in Argentina

(iv) In terms of organization, the supervisory units are reasonably efficient in Uruguay, Argentina, Brazil and Chile, but need a major overhaul in Paraguay.

(v) Regarding freedom from political interference, bank supervision is reasonably autonomous in Uruguay, Argentina and Brazil. It suffers from mild political interference in Chile, but there is major interference in Paraguay

C. Capital Markets:

In Chile, capital markets have been expanding rapidly in recent years Total stock market capitalization in 1992 was equivalent to 82 5 percent of GDP, up from 34 percent in 1980. The most heavily traded instruments are fixed-yield bonds, mortgage notes, letters of credit and promissory notes of the Treasury, which combined represent an annual trading of 63 percent of GDP in 1992. Time deposits, commercial promissory notes and promissory notes that can be redeemed at the Central Bank are also heavily traded, for annual amounts equivalent to 46 percent of GDP in 1992 Private equity is not as dynamic annual trading reached 5 73 percent of GDP in 1992 Yet, the growth rate of equity trading has been impressive, considering that in 1984 trading was equivalent to just 0 27 percent of GDP.[65]

The dynamism of institutional investors lies behind this impressive performance of capital markets in Chile Insurance companies, for example, have placed funds in real estate notes, for an annual equivalent of 9 29 percent of GDP in 1992, up from 1.63 percent in 1980. Likewise, private corporations have issued bonds for an annual equivalent of 5.49 percent of GDP in 1992, up from 0 18 percent in 1980 Most significant, however, has been the contribution of the private pension funds (Administradoras de Fondos de Pensiones, or AFPs), which have grown tremendously. In fact, while in 1981 the total financial resources placed by these entities represented just 0 93 percent of GDP, in 1992, this figure had increased to 34.5 percent. Roughly, the AFPs divide the investments into fixed-yield bonds (70 percent), private equity (24 percent) and time deposits in banks (6 percent).

A sound regulatory and legal framework also explains the vitality of Chilean capital markets. Since 1980, the set of regulations that governs capital markets has undergone constant revisions and modifications for improvement. These have included, for example, stipulations that force board members, major equity holders and top executives of publicly held companies to disclose every equity transaction in which they are involved, as well as on any event and/or operation that may significantly affect the health of the firm. In addition, all financial instruments that are traded must be classified according to risk. In the recent past, serious problems existed in this area, because the firms that classified risks were owned at the same time by the firms that issued the titles This constituted an unacceptable conflict of interest. A new reform of the capital markets law has reportedly corrected this anomaly

In <u>Argentina</u>, the stock market is very small compared to other countries with economies of equal size. More than an vehicle to raise capital, the stock market is mainly a venue for speculation. Its lack of development and need for improvement is evident from a recent report from The World Bank.[66]

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[65]For a detailed description of the evolution of capital markets in Chile, see Arrau (1994). The statistics cited are drawn from this work. Our discussion has also benefited from the insights that it provides.

[66]World Bank (1994b).

"While the stock markets are capable of generating sizable new funds, the Argentine corporate population is very small, and new equity issuance even smaller The principal issuer-related problems are the owners' unwillingness to dilute control, the deeper problem of under-reporting of assets and profits by some of the small and medium businesses, the lack of profitability of many industries during the structural adjustment process, the unused debt capacity of many corporations, and the high concentration and fragmentation among issuers. The major institutional and market-related problems are the prevalence of insider trading and speculation, the consequent skepticism about equity as a source of funding and an investment vehicle, the underdevelopment of investment banks, and lack of liquidity in all but a handful of stocks. The principal regulatory problem remains the delay in enactment of a modern insider trading law. ."

The government issues treasury bills and long term bonds which are primarily purchased by banks. Firms also issue bonds and commercial paper, but publicly offered securities offer tax advantages over private placements.[67] A private pension funds system was introduced in 1994 but is not developing as rapidly as Chile's.

Brazil has two large stock markets, one in Sao Paulo and the other in Rio de Janeiro. 90 percent of the Sao Paulo index corresponds to transactions from multinational corporations and state-owned firms heavily involved in oil, mining, agribusiness and manufacture. Trading of private equity, government securities and commercial paper is well developed Corporate bonds, however, are not very developed Open market operations of government securities are heavily used, crowding out the private sector as a consequence. These are mainly short-term instruments, traded over-the-counter; the process is supervised by the Central Bank and the Association of Securities Dealers, a highly sophisticated organization

Private equity and corporate bonds could develop faster were it not for the fact that the government absorbs so much liquidity through offerings of state-owned or controlled corporations In this regard, as much as 70 percent of all secondary market trading is concentrated in big state corporations This leaves little liquidity for small and medium sized firms High corporate taxation, around 48 percent, also hinders firms from going public [68] This rate provides firms with an incentive to try to conceal

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[67]Ibid.

[68]This is one of the unresolved problems that Mercosur faces Corporate taxation is much lower in Argentina, approximately 30 percent. Consequently, investors may strive to establish firms in Argentina for exports of manufacturing products to Brazil. This could lead to trade imbalances, and hence, tensions within the bloc.

profits

In the 1970s, the government underpriced issues but this problem has been largely corrected since 1990. But it is still not atypical for investment banks to resort to this practice currently. While the regulatory framework reasonably protects investors against fraud and insider trading, enforcement is unfortunately problematic Requirements about disclosure of health of banks and corporations which trade stock and bonds are adequate but applicable only to private firms [69] One problem is that this information does not reach small and medium sized investors.

Insurance, hedging and futures markets are well developed in Brazil. With respect to pension funds, a total of US$ 55 billion was raised by corporate firms, state firms, banks and social security in 1994. There are, however, complicated restrictions for the investment of these funds.

In <u>Paraguay</u>, the stock market is virtually non-existent A new set of regulations was passed in 1991, but serious institutional and market-related problems render them ineffective. The most important factor is that firms are family-owned and reluctant to go public because they enjoy profits from illegal operations in the vast underground economy. In <u>Uruguay</u>, the stock market is very small The main instrument that is traded is government securities, mostly denominated in dollars. This country needs modernized legislation and clear rules on property rights. In addition, the law discriminates against financing through equity issues as compared to bank loans, because interest payments are tax deductible.

D. Summary:

For several consecutive years, Chile has posted strong economic performances and this has clearly benefited its banking industry and its capital markets One of the cornerstones of this success has been a pragmatic monetary policy that has prevented a real appreciation of the peso. The country also boasts the highest savings ratio of the Hemisphere These two factors account for the relative ease with which the country managed the crisis unleashed by the collapse of the Mexican peso Overall, the banking sector seems to be profitable and has high quality assets. In recent years,

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[69] State-owned firms, as a rule, do not release information to the public, unless they are trying to raise funds from foreign sources.

the expansion of its capital markets has been impressive In this regard, the introduction of private pension funds has played a big role through investments in bonds and corporate equity.

Argentina, unfortunately, faces economic recession ahead, and this is bound to affect its banking sector negatively. The authorities are wedded to the rules of the Convertibility Plan which has clearly benefited the economy, but which may not survive if a severe bank liquidity or solvency crisis forces the Central Bank to bailout the banking system. Even before the crisis, the banking sector was highly inefficient, characterized by large intermediation margins, high concentration and poor quality of portfolios The system should contract in the near future with the privatization or liquidation of provincial banks and with mergers or liquidation of a large number of small private commercial banks. The capital market remains undeveloped, a medium for speculation rather than for raising capital

Brazil will continue to wrestle with the obstacles that have impeded a thorough public sector reform and that explain the high inflation rates posted for so long. At time of this writing, the outcome remains uncertain The fact that very little progress has been made with respect to the restructuring and/or privatization/liquidation of state banks does not bode well for the future On the other hand, the privately-owned commercial banks resemble those of Chile more than of Argentina they are dynamic and modern, yet poorly supervised The country also boasts the largest stock market of the Hemisphere outside the United States, but trading is heavily concentrated in government securities. This deprives many small and medium sized firms of liquidity In addition, high corporate taxation fuels tax evasion in this country. This is a factor that makes firms wary of going public, for otherwise they would be forced to release accurate financial information.

Economic conditions in Argentina and Brazil largely determine the dynamism of the economy and of the banking sector in Paraguay and Uruguay Banks in Paraguay are owned by powerful economic groups of the country whereas in Uruguay, foreign-owned banks, which operate under a framework of offshore banking, predominate Lack of effective supervision is a big problem in Paraguay, whereas the main constraint in Uruguay lies in the distortions that are transmitted by inefficient state banks. As regards stock markets in these countries, they are very small and for all practical purposes undeveloped

IV. The Caribbean

This section discusses the following countries Dominican Republic, Haiti, The Bahamas, Barbados, Guyana, Jamaica and Trinidad & Tobago The ECCB members were not included in this analysis.[70]

A Policy Issues

In general, financial markets in this region are poorly developed Capital markets, in particular, are quite small, mostly concentrated in trading government securities and development bank bonds Stock exchanges exist in Barbados, Jamaica, Trinidad & Tobago and Dominican Republic, but they do not report much public offering either of private commercial debt or of private equity Therefore, most financing of private firms is provided by commercial bank lending and from retained earnings

The main problem of financial markets in this region does not lie as much in the mobilization of domestic and foreign savings as in firms' access to capital at reasonable cost. Furthermore, the region has yet to implement major policy reforms.

In "Caribbean Countries Policies for Private Sector Development," The World Bank identifies common problems that act to retard the development of financial markets in the entire region [71]

(i) Historically, the region suffers from severe macroeconomic imbalances. For example, by the end of 1992, budget deficits as percentage of GDP were 5 0 percent in Haiti, 3.9 percent in the Bahamas, 2.3 percent in Barbados, 6 3 percent in Guyana and 3 6 percent in Trinidad & Tobago. Jamaica was the exception in that year, with a surplus equivalent to 4 4 percent of GDP. Budget deficits are in part due to unproductive public expenditures, but also to widespread tax evasion

(ii) Another important manifestation of macroeconomic imbalances has been the tendency for overvaluation of exchange rates In 1992, for example, real exchange rates, as compared with 1985, had

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[70] ECCB is composed of the following countries: Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St Kitts and Nevis, St Lucia and St. Vincent and Grenadines.

[71] See World Bank (undated).

appreciated by 10 percent in the Dominican Republic, by 3 percent in The Bahamas, and by 2.5 percent in Barbados In Guyana, Jamaica and Trinidad & Tobago, this overvaluation was quite severe, 63 5 percent, 29 percent and 40 5 percent, respectively

(iii) The overvaluation of exchange rates creates incentives for capital flight. The government tries to ameliorate this with very high domestic interest rates, which far exceed international rates This, in turn, makes financing very costly.

(iv) Public expenditures are in part financed by high reserve requirements on bank deposits By the end of 1994, these were set at 20 percent in Dominican Republic, both on demand and time deposits; 25 percent in Jamaica and 20 percent in Trinidad & Tobago, also on both demand and time deposits; in The Bahamas, they were set at 20 percent on demand deposits and 15 percent on time deposits; Barbados exhibited the highest level, 29 percent on both demand and time deposits, whereas Guyana presented the lowest levels, 11 percent on demand deposits and 9 percent on time deposits [72]

(v) High reserve requirements contribute to high bank spreads which, in turn, explain the high cost of credit. Spreads are estimated to be 10 to 12.5 percent in Jamaica, 6 to 8 percent in Trinidad & Tobago and 6 percent in Barbados [73] In fairness, reserve requirements are not the only factor which explains high spreads. Large bank overhead seems to play an even bigger role, since spreads have not been reduced even when reserve requirements have been lowered [74]

(vi) Financial intermediation by banks is also characterized by excessive reliance on overdrafts and emphasis on collateralized loans. Overdrafts constitute fifty percent of business loans, a particularly dangerous situation because it increases systemic risks, especially when used to finance long-term, non-amortizable loans. Emphasizing collateral requirements, on the other hand,

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[72] Westley (1995).

[73] World Bank (undated) The report argues that these spreads are high in comparison with North American standards.

[74] Ibid

signals banks' strong preference for well-to-do customers, and, as a result, effectively excludes vast numbers of potential customers from formal financial services This underlines acute market segmentation and the lack of a critical mass that would otherwise facilitate a significant reduction of intermediation costs.

(vii) The development of the banking sector is also hampered by lack of confidence that results from the recently severe bank failures in Barbados, Trinidad & Tobago and Dominican Republic, all of which harmed depositors

(viii) Several important factors have slowed down the development of the equity market, including, on the supply side, the predominance of family-owned firms with proprietors that are reluctant to give up control; the relative abundance of bank credit; and a tax regime that penalizes equity Demand has been suppressed by low personal incomes; investor ignorance and fears of market manipulation by insider trading; and strong preference for bank deposits

(ix) Inadequate legal and regulatory frameworks have constrained capital market development in the region. Some of their important features are. (1) excessive foreign exchange regulations, such as government approval on equity flows, borrowing and repayments, and restrictions on domestic borrowing by non-nationals; (2) differing tax codes and the absence of comprehensive tax treaties, as well as heavy (and enforced) withholding taxes; (3) inadequate company by-laws for example, disclosure requirements are inappropriate, minority shareholders are not protected at all, and new stock can only be issued at par; (4) no regulations concerning the use of internationally accepted accounting and reporting standards, and (5) inadequate clearing and settlement standards.[75]

B. Particular Features of Financial Markets:

Guyana has seven commercial banks, two of which are foreign-owned. There are no barriers to entry, with rules that apply equally to domestic and foreign entities.

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[75]Ibid.

In general, the development of the banking sector is constrained by the small size of the economy and by widespread poverty. Therefore, loans concentrate on trade finance and some consumer loans, but credit cards are not developed Poverty also explains the low level of domestic savings The maturity of these scarce deposits averages three months and loans are very short term as well Interest rates on both loans and deposits are positive in real terms and market-determined since 1990

The legal system constrains the banking sector, as it is not reliable to execute foreclosures in case of non-repayment of loans. The IDB is reportedly interested in strengthening this area, as well as in finding ways to induce banks to lend to small farmers However, the IDB has postponed a program aimed at establishing a deposit insurance scheme.

Capital markets have no chance of developing in Guyana as long as the economy does not grow Only ten companies have shares traded, and they trade through advertisements in newspapers. Clearly, the priority in this country is to improve economic policy. At present, the economy is paced by an uncontrolled process of dollarization that could bring unwelcome consequences in the near future. However, no solution will succeed until the foreign debt is significantly reduced.[76]

The use of targeted credit has been a disaster, only benefiting the well-to-do. However, it is encouraging that the volumes have been declining lately Furthermore, privatization of state-owned banks is proceeding quickly Whether this process will end up alleviating poverty remains to be seen

The Bahamas, with its reputations as a tax haven and an important offshore financial center, holds no barriers to bank entry. As of December 1992, there were 404 offshore banks and trust companies, of which one quarter were branches or subsidiaries of banks and companies based outside The Bahamas and another quarter were Eurocurrency branches of foreign banks and trusts.[77] Both the locally-based and international banks serve the domestic market There is one state-owned development bank that may be privatized in the near future.

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[76]Relative to GNP, Guyana has the largest foreign debt among the countries in this region By the end of 1991, GNP was US$ 233 million, but the stock of debt reached US$ 2 billion. In per capita terms, GNP was US$ 290, whereas foreign debt was US$ 2,400.

[77]The Economist Intelligence Unit, 1994-95

Maturity of loans is somewhat longer than in the other countries of the region A good part of credit finances tourism. The interest rate on lending is the lowest in the region and fully market-determined. Most deposits are short-term. Only foreigners can hold dollar accounts. Bahamians place much of their savings outside the country, probably because of fears of currency devaluation [78]

Haiti counts nine commercial banks The two state-owned banks concentrate close to 40 percent of all system assets and are up for privatization Three banks are foreign-owned -- Bank of Boston, Citibank and Bank of Nova Scotia A state-owned agricultural development bank has folded

The distinguishing feature of this country's banking system is its concentration [79] The nine banks vie for the demand of just 2,000 borrowers, a close-knit, wealthy group whose composition has not changed much over the years. The owners of banks and related parties are included in this group. In fact, substantial volumes of credit are destined to owners. This borrower concentration largely explains why interest rates show little sensitivity to any liberalization of interest rates To wit, lending rates remained unchanged, at 14 percent, well into the early 1990s

The embargo had little effect on this structure. Indeed, banks reported a nominal rise in their portfolios by 74 percent in the period 1991-1994 Most of credit in this period was probably destined to finance foreign exchange transactions and speculation by the well-to-do customers

The Haitian economy as a whole must undergo a vast transformation in order to make financial markets modern and more competitive. The current bank law must be amended to include prudential norms and supervision Any decision on capital adequacy must carefully weigh the objective of expanding the system as rapidly as possible with the need to prevent entry of groups with no banking experience This will be difficult as long as the Central Bank has no autonomy. Another major problem is that the judiciary is wholly inefficient and corrupt, indeed some observers suggest that a large proportion of judges do not even hold law degrees In addition, there is an urgent need to modernize the public registry system, improve land titling, and design

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[78]The Bahamian dollar is the legal tender and has been fixed at par with the US dollar for a long time Many analysts believe that the country would be better off if the local currency were eliminated altogether.

[79]These insights are based largely on discussions with Mark Flamming, of the Inter American Development bank.

clear and predictable rules on foreclosures

Twenty private commercial banks operate in Dominican Republic, of which three are owned by US, Canadian and Spanish concerns There are no plans for the privatization of the two state-owned banks in the near future. The structure is heavily concentrated. the top three banks control 62 percent of all banking system assets[80] Yet, barriers to entry have been coming down, and in April 1992, the system was reformed to allow for multipurpose banking In the same year, the Central Bank removed interest rate controls which remain market-determined to this day The majority of loan and deposit maturities are short-term.

Banks offer a variety of financial instruments, letters of credit, loan guarantees, credit cards and even small mortgage loans. Conceivably, the system could expand further if the legal system becomes more expedient and reliable in order to execute foreclosures, and if banks show more interest in exploring the vast market of small customers. Of course, caution is necessary In the late 1980s, the system was rocked by major bank and non-regulated financial entity failures following an uncontrolled and unsupervised expansion of lending activity The Central Bank was ordered to bailout the banks, but the strategy left the management of the failed entities largely intact. Despite this history, there are still no clear procedures to follow in case of bank insolvency. Furthermore, no system of explicit deposit insurance has been put in place

A small stock market has been in operation since 1992 Private equity trading is very light most companies are family-owned, with neither the expertise nor the willingness to go public In addition, a regulatory framework is not in place yet; not surprisingly, many experts believe that the handful of transactions are not transparent

Trinidad & Tobago has eight commercial banks, of which three are subsidiaries of foreign banks The market structure is heavily concentrated, with two large banks holding over fifty percent of the system's assets After Barbados, the banking system in Trinidad & Tobago features the highest ratio of bank deposits to GNP[81]

[80] World Bank (undated).

[81] By the end of 1991, it was 46 7 percent, compared with 51 5 percent in Barbados. Jamaica came in third in the region, with a ratio of 25 3 percent Source World Bank (undated)

In the mid-1980s, the government forced the commercial banks to provide credit to ailing state-owned companies. The process of privatization has rendered this practice less common Therefore, banks have more freedom to develop financial products such as trade finance, loan guarantees, credit cards and even home mortgages. Trinidad & Tobago is one of the few countries in the Hemisphere where banks do offer long-term and medium-term loans. Average maturities are 7-10 years for the former and 2-5 years for the latter

The state-owned financial entity, the Development Finance Limited, was recently restructured and successfully privatized.[82] From 90 percent of total equity shares, the government now holds 28 percent. Local and foreign investors are now the main shareholders and the quality of its portfolio has been greatly improved. In financial terms, this has been an unequivocally spectacular turnaround, and net profits have been increasing. The entity disburses loans and also makes investments in equity, not just in Trinidad & Tobago, but also in other countries of the region. Nonetheless, this entity has not evolved into a typical development bank, one which would cater its services to marginalized customers. Its portfolio consists of only 100 borrowers and lending in foreign currency has been on the rise [83] There remains one state bank, the Agriculture Development Bank, which controls 10 percent of the total bank system loan market

Banking is constrained by the fact that the legal system tends to favor borrowers. Regarding solvency, banks were shaken when the oil boom ended in the early 1980s and one, the International Trust, went under At present, procedures in case of bank insolvency are sound It must also be stated that there is a government-run, well managed and technically independent deposit insurance corporation, established in 1989

The market for government securities is very active, and used as instrument of open market operations. While these securities do offer competitive yields, banks are forced to buy them (though they can use them as part of required reserves) The equity market is very small, and heavily concentrated in shares of six commercial banks and the three largest conglomerates of the country The stock exchange is governed by the Securities Industry Act, whose main deficiencies, according to a World Bank report include:[84]

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[82]Ibid.

[83]Ibid.

[84]Ibid.

-overly stringent listing requirements
-insufficient information disclosure
-lack of delisting criteria
-inadequate specification of bond issues
-low capital requirements for brokerage firms

Other important constraints to the development of the stock market include lack of appropriate supervision and oversight, and unwillingness of owners to dilute ownership. On a positive sign, pension funds are growing fast and could potentially trigger an expansion of the stock market.

Finally, with respect to policy issues, deposit and loan rates have been market-determined since the late 1980s, but the lending rates of the Agricultural Development Bank have not been liberalized yet. Targeted lines of credit have been reduced lately, and there are plans to reorient them away from agriculture in favor of rural projects

In 1993, Barbados had 19 offshore banks, mostly branches of Canadian and British banks. There is one major domestic bank and two minor ones. In this concentrated market structure, four foreign banks account for 70 percent of all bank system assets Banks that were established before 1985 are not bound to meet the capital adequacy standards, but all newly formed banks must abide by minimum capital requirements.

Like Trinidad & Tobago, banks in Barbados also offer long and medium-term loans Unlike this country, however, Barbados has failed to privatize its development entity, the Barbados Development Bank (BDB), and the Barbados National Bank (BNB), a public commercial bank which holds thirty percent of total bank system loans. The main purpose of the BNB is to offer long-term credit to residents at below-market interest rates Not surprisingly, it suffers from large losses, high administrative costs and a large non-performing portfolio By the end of 1992 it had a negative net worth [85] The IDB has offered technical assistance to shut it down and replace it with a leaner entity. A merger with the BNB is also a possibility

Banking in Barbados endures a legal system that favors borrowers. Bank failures have also occurred in recent times, but procedures in case of bank insolvency are adequate now The State implicitly guarantees deposits of domestic banks, whereas foreign banks are presumably covered by their parent

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[85] Ibid

organizations.[86]

The stock market auctions short-term, high-yield government securities weekly. Long-term government securities have not been developed. The stock market is suitable for "15 quoted companies and relatively small turnover".[87] But unlike Trinidad & Tobago, Barbados has an adequate regulatory framework In this regard, listed companies must undergo "strict" reporting and disclosure requirements as well as independent audits.[88] Nevertheless, the exchange rate, widely believed to be overvalued, penalizes the expansion of trading.

Finally, in terms of policy, interest rates are free on loans and deposits with the exception of the loan rates of BDB and BNB Targeted credit has been dropped formally, after negative experiences with the hotel industry Like Trinidad & Tobago, there is a capital gains tax.

By the end of 1991, Jamaica had 33 commercial, merchant and cooperative banks, three of which were foreign-owned [89] There are two state-owned commercial banks, the Industrial Bank and the Agriculture Bank. There are no plans either for privatization or liquidation [90] In addition there is a development entity, the Trafalgar Development Bank (TDB), allegedly a true success story that was set up with assistance from USAID.[91]

One of the most important constraints in banking is the high level of reserve requirements Unfortunately, given the high inflation rate posted in 1994 (33 percent), it is unlikely that they will lowered anytime soon.

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[86]Unless this coverage is explicitly specified, there is a chance that the State may pick up the tab should foreign banks falter. This is precisely what happened in Uruguay in the 1980s with the failure of foreign banks. They were recapitalized by their parent organizations, but the injection of funds was charged as a loan to the Uruguayan government

[87]World Bank (undated).

[88]Ibid.

[89]Ibid

[90]Westley (1995).

[91]World Bank (undated).

C Bank Regulation and Supervision.

According to Westley (1995), with regard to bank regulation

(i) Reasonable capital adequacy standards exists in Dominican Republic, Jamaica, Trinidad & Tobago, Guyana and The Bahamas. Barbados seems to be moving in this direction, whereas Haiti still has a long way to go.

(ii) Reasonable provisioning for bad loans exists in Dominican Republic, Jamaica, Trinidad & Tobago, Guyana and The Bahamas. Improvements are expected in Barbados Haiti's reform lies in the distant future

(iii) Multipurpose banking exists in Dominican Republic, Jamaica, Trinidad & Tobago, Guyana, The Bahamas and Barbados

With respect to the entities in charge of bank supervision, reform in Haiti must start from the beginning Westley's findings for the other countries are the following

(i) Quantity of personnel is reasonably good in Trinidad & Tobago and The Bahamas It needs some upgrading in Dominican Republic, Jamaica, Guyana and Barbados.

(ii) In Trinidad & Tobago and the Bahamas, quality of personnel is reasonably good It needs some upgrading in Dominican Republic, Jamaica and Barbados A major overhaul is needed in Guyana

(iii) Salary levels are competitive in Jamaica and The Bahamas. Some upgrading is needed in Dominican Republic, Trinidad & Tobago and Barbados, but major improvement is required in Guyana

(iv) Organization is reasonably good in Dominican Republic, Jamaica, Trinidad & Tobago, Guyana, The Bahamas and Barbados

(v) With respect to freedom from political interference, the entities are autonomous in Jamaica, Trinidad & Tobago, The Bahamas and Barbados In Dominican Republic and Guyana, the entities suffer from major political interference.

D Summary:

The expansion of financial markets in this region is constrained by severe macroeconomic imbalances Widespread poverty in Dominican Republic, Guyana, Haiti and Jamaica, as well the fresh memories from severe bank failures in Barbados and Trinidad & Tobago constitute important constraints. Firms in these countries obtain capital mainly from bank loans In general, though, loan terms are very costly for borrowers, due to high reserve requirements but also to large bank overhead. Overall, there is acute market segmentation, with the private commercial banks being unwilling or unable to handle small size loans.

There are four stock exchanges in the region, in Barbados, Jamaica, Trinidad & Tobago and Dominican Republic. The exchanges of Trinidad & Tobago and Barbados are the most important, primarily active in the trading of government securities None of the four stock exchanges report much offering of corporate equity and this will remain so until firm owners are willing to dilute control, incomes are raised, and investor confidence is regained.

CHAPTER THREE

Recommendations

Properly implemented financial market reform will contribute to economic growth and development Within the context of the Hemisphere, this remains a distant goal, not necessarily due to lack of effort, but because of the presence of economic and institutional constraints that act to thwart the intended goals of reform.

Sustained expansion of financial markets cannot take place under conditions of overall macroeconomic fragility. Obviously, this fragility is lessened with a firm, coherent monetary and fiscal policy. For decades, however, the governments in the Hemisphere did not act responsibly in this regard, which, consequently, severely undermined public confidence in economic policy making The macroeconomic policy reversal of recent years is definitely a step in the right direction. However, policy makers, perhaps with the exception of those in Chile, have not found answers to the vulnerabilities to external shocks, nor to the dramatic inequality that permeates the economic and social landscapes of the Hemisphere. It is particularly worrisome that many analysts believe that inequality in several countries -- in the form of falling real incomes and/or increased unemployment and underemployment among the socially disadvantaged -- has been worsening in recent years.

As long as the problem of inequality is not confronted directly, no financial policy reform will succeed Fundamentally, the cause is twofold built-in pressures for redistribution can easily foment inflation, and, inequality denies financial markets the chance of reaching a critical mass that is necessary to substantially reduce intermediation costs This unfortunate scenario naturally relates to two predominant economic features in so many countries of the Hemisphere market segmentation and the vast marginalization of economic agents. The existing distribution of productive assets plays an essential role in affecting the extent to which poor people in Latin America and the Caribbean can take advantage of market opportunities Hence the need to address this distribution problem is all the more pressing.[92]

The resolution of these fundamental economic problems will take

[92] For a thorough discussion of this issue, see USAID (1994).

time. All countries, particularly with the benefit of donors' technical assistance, could rapidly enact the adoption of measures to introduce the institutional ingredients of successful finance. As outlined in this Report, such measures include adequate legal systems, requirements for the disclosure of information, Basel-like prudential norms, and efficient supervision of financial entities As this Report has demonstrated, many countries have already made substantial advances in these fields The problem, however, lies in enforcement. Generally, in almost all countries of the Hemisphere, enforcement is found wanting, either because the supervisory agencies are poorly organized or staffed, or because they do not enjoy technical and political autonomy. This area needs much improvement, but this is beyond the scope of outside help, for it pertains solely to the domain of governments -- to their willingness and commitment to embrace a process that will ultimately lead to institutional strengthening This process will require patience

In the meantime, it is possible to pinpoint specific areas where useful assistance can be provided by USAID's Bureau for Latin America and the Caribbean. Such assistance stands a better chance for effectiveness if it is properly coordinated with that of other donors currently working in many countries of the Hemisphere Donor coordination must be planned to minimize the cumbersome bureaucratic details that could complicate the design and execution of technical assistance programs. If there is no cooperation donors could easily have overlapping programs with sometimes contradictory agendas. Certainly a well-orchestrated alliance could effectively pool the financial resources and technical knowhow of The World Bank, the Inter American Development Bank (IDB) and USAID

In principle, the reform of financial systems, unfortunately, requires the commitment of vast financial resources. For example, lowering reserve requirements may entail sudden fiscal imbalances. Countries, therefore, need help to support fiscal budgets. The privatization process of state banks is also very costly because it normally entails numerous studies, the restructuring of banks prior to their divestiture, and follow up. Fortunately, both The World Bank and the IDB have the wherewithal to finance these programs of technical assistance. Currently, the IDB is particularly active with a number of programs in several countries Some of these actions include the following

(i) Peru is one of the countries that enjoys substantial technical assistance from this donor There is a multisectoral credit operation in execution which consists of a US$ 100 million loan to COFIDE, a second tier bank There is also a microenterprise global credit project that will be disbursed through COFIDE and accessed by commercial banks, *cajas rurales* (small rural banks) and probably non-governmental organizations (NGOs) if they can become quasi-financial entities. The provision of technical assistance to the *cajas rurales* is currently being contemplated Finally, there is a grant to support the Securities Exchange Commission (SEC) equivalent in Peru, in its quest to meet G-30 standards for trading and settlements.

(ii) For Venezuela, there are plans for a major technical assistance program that applies to all major oversight agencies in the financial sector, including the superintendency of banks, insurance, FOGADE (the deposit insurance entity), the Comisión Nacional de Valores (stock exchange), and the Central Bank The program includes studies, training, supervision and supply of computer equipment The program proposal is for a US$ 12-15 million loan which will probably be approved in September.

(iii) In Trinidad & Tobago, the IDB supports the restructuring of the Agricultural Bank, the passage of a new securities industry legislation and the creation of an SEC-type organization. In addition, it is involved in assisting credit unions.

(iv) In Barbados, this donor is involved in upgrading the government's securities market and second tier mortgage banks It has been unsuccessful, so far, in persuading the government to shut down the Barbados Development Bank

(v) In El Salvador, there is a US$ 1.8 million grant to support bank supervision There are also plans to offer a multi-sectoral credit of US$ 100 million to follow through on pension fund reform and strengthening of capital markets, US$ 390 thousand for institutional strengthening of second tier banks, and technical assistance to entities that provide financial services to microenterprises.

(vi) In The Bahamas, a multilateral sector loan is currently in execution One of the areas that is in need of technical assistance is the insurance market, whose regulatory framework is totally outdated.

(vii) In Guyana, a financial sector reform loan will be presented to the Board in late August 1995. It includes reforming bank laws, privatization of state banks, strengthening the regulation of the securities market and developing rural financial markets to help small farmers

(viii) In Jamaica, this donor is assisting credit unions.

(ix) In Costa Rica, the IDB is running a microenterprise lending program and a very large investment sector loan (US$ 100 million) to support open market operations and financial deregulation

(x) In Honduras, a multi-sectoral loan was approved in 1992, but disbursement is on hold, pending the passage of a law to modernize the financial sector.

(xi) In Nicaragua, the IDB has a strong presence. It financed the restructuring of the BND and it has developed programs to promote lending to small customers

(xii) In both, Guatemala and Dominican Republic, there are financial sector reform loans that focus primarily on developing mechanisms of long-term finance and on institution building.

The World Bank is also playing an important role For example,

(i) In Argentina, it provides technical and financial support for the privatization of provincial banks and for the consolidation of private banks

(ii) In Venezuela, it plans to give a technical assistance package oriented towards the strengthening of FOGADE and the bank supervisory agency This assistance will probably be coordinated with the IDB

(iii) In Bolivia, there is a structural adjustment loan that includes assistance for the final liquidation of the state banks

(iv) In Peru, an office of The World Bank recently opened. There are plans to offer technical assistance for the promotion of rural financial entities.

(v) In Paraguay, The World Bank is involved in strengthening bank laws and the superintendency. Training of executives of the superintendency has been emphasized It is recommending the privatization of state concerns, but with no success so far.

(vi) In Guatemala, it is preparing a financial sector loan and a program of technical assistance that includes the recommendation for the privatization of BANDESA, the largest state bank.

(vii) In Colombia, The World Bank participates in a task force that is reviewing capital markets.

(viii) In Jamaica, it has plans to review the financial conditions of development banks and to strengthen the legal and supervisory frameworks.

What, then, are the specific areas that look most promising for the implementation of useful, highly effective programs of technical assistance by USAID? On the basis of this Report, the following recommendations can be made:

First, the Bureau can facilitate a successful beginning for the Council of Securities Regulations of the Americas (COSRA). This was created during the Miami Summit of the Americas with the purpose of harmonizing regulations of capital markets in the Hemisphere. In this regard, *the Bureau can join efforts with the Inter American Development Bank and offer its resources to carry out a study that will unveil information on what needs to be done to move the harmonization forward.* By the same token, *the Bureau can propose studies aimed at harmonizing bank regulation and supervision norms. This task can be approached regionally first; probably the Central American region would be an appropriate starting point.*[93]

Second, the Bureau can contribute by undertaking the complementary tasks that must accompany financial reform assistance packages For example, technical assistance to reform legal systems is sorely needed almost in all countries of the Hemisphere As regards the banking sector, *the Bureau can offer resources to coordinate efforts aimed at strengthening the capabilities of supervisory agencies.* Programs of this nature promise very high returns, given the proclivity of banks to participate in so many *préstamos*

[93] In 1994, Claudio González-Vega of Ohio State University and Arnoldo Camacho of INCAE prepared a proposal to undertake this initiative. The Bureau could build from this proposal

relacionados, to overstate assets, and to withhold or doctor information that is vital for customers Almost all countries in the Hemisphere need help in this area to some degree, though this necessity is particularly pressing in Guatemala, Honduras, Paraguay, Argentina, Venezuela, Ecuador, Guyana and Haiti. Another area of supervision that is critically important is the training of personnel, since the current qualifications of supervisors resemble those of auditors more than of bankers Given the profound changes that the banking industry has sustained in the last twenty years, supervisors, if they are to succeed, must be trained as bankers. Therefore, ***the Bureau must consider offering Hemisphere-wide seminars on the most modern and updated techniques of bank supervision.***

With respect to capital markets, the entire Hemisphere, in general, suffers from severe institutional shortcomings. The most important of these are: faulty information and poor requirements on the disclosure of information, irregularities such as insider trading and fraud, lack of access for small and medium-sized firms, lack of rights for minority shareholders, absence of dynamic institutional investors and last, but not least, populations whose financial culture is very poor. ***The Bureau, in this regard, can offer country-specific technical assistance programs to correct these problems.*** In addition, not unlike the programs for bank supervisors, ***the Bureau can also offer Hemisphere-wide seminars on the most advanced techniques for the supervision of capital markets.***

<u>Third</u>, if scarce resources force only one alternative, either strengthening the banking sector or modernizing capital markets, the Bureau should unequivocally support the former, since returns from strengthening commercial banks are much higher. This is because a modernized commercial banking system stands a better chance of reducing segmentation in finance than capital markets. In fact, commercial banks are unambiguously more useful vehicles than stock markets to foster the incorporation of the vast poor into formal financial markets. The available evidence clearly points out that trading in stock markets is heavily concentrated in a handful of local firms most of which are family-owned Perhaps in time, this situation will change Finally, as revealed by the Mexican crisis, in countries which have embraced an all-out opening of capital accounts, stock markets run the risk of excessive, speculative trading by foreigners with ensuing unwelcome consequences

Given that the banking system should take priority over capital market development, what sort of technical assistance programs must be offered? Two are recommended The first is to publicize the virtues of financial services -- credit and savings facilities -- for microentrepreneurs As indicated by this Report, some private commercial banks in a few countries are already experimenting with small loan programs If this practice is generalized in most countries, and if these programs also include savings mobilization, the entire Hemisphere will have a made a gigantic leap forward to expand financial markets, making them an important partner of economic development. ***The Bureau, in this regard, can undertake a study on the successful examples, and offer Hemisphere-wide seminars on the conditions that make them possible.***

The second program is equally far reaching. It relates to the financial sustainability of commercial banks in times of economic transition and the design of adequate deposit insurance schemes Very often, as noted in this Report, banks undertake risky behavior either because they thoroughly lack the capacity for the valuation of and risk assessment of assets, or because their owners and managers do not face the consequences from failure Benefits from easy access to a lender-of-last resort facility and from either implicit or explicit cheap deposit insurance are also ingredients that contribute to risky behavior. As past experiences have painfully demonstrated, losses are enormous and are usually borne by the population at large For all these reasons, ***the Bureau should consider two options: (a) disseminating studies that pinpoint causes and conditions that trigger massive bank failure; in this regard, a good case study could be made out of the Venezuelan experience, and (b) undertaking comparative studies on the issue of deposit insurance, an area that, we would emphasize, has not been adequately investigated by other donors.***

Fourth, the Bureau can make a lasting contribution in financial policy reform through policy dialogue. Three specific areas stand out. Regarding state banks, ***the Bureau can help governments redefine the role of these entities through country-specific reports.*** If liquidation is the sovereign decision, the Bureau can assist in preserving the state banks' customer files by setting up credit information mechanisms that could be useful for other participating financial entities In this aspect, the importance of information on the creditworthiness of customers to a financial entity cannot be overemphasized If this information is lost, the surviving financial entities will ignore the state bank customers rather than undertaking costly investments to assess them In addition, if the state bank is liquidated, ***the Bureau can assist in assessing the viability of transferring profitable branches in the countryside to successful cooperatives or rural entrepreneurs.***

Another area relates to the liberalization of deposit rates. Competition to attract deposits may result in a sharp increase of deposit rates, which could potentially induce bank risky behavior. This, combined with volatility of interest rates, must be avoided at all costs, otherwise financial systems will be unstable. For these reasons, ***the Bureau can assist countries in finding efficient mechanisms to ensure that interest rates remain positive in real terms and, above all, stable.***

The third area relates to external liberalization. The insertion into international financial markets has been undertaken in the Hemisphere with such zeal that, in some countries, financial transactions grow at a faster pace than trade transactions In other words, some countries probably experience a more rapid integration of financial markets than of goods markets This is a cause for concern since an all-out opening of the capital account may result in severe currency overvaluation, large current account imbalances, and a currency substitution process. These consequences may endanger the stability of the banking system, as the recent crisis in Mexico has painfully shown Therefore, ***in coordination with the Treasury Department and with the other Washington-based donors, the Bureau can contribute in finding ways to avoid the pitfalls from external liberalization.***

ANNEX A:
Questionnaire

1 Banking Sector

(a) Is the banking sector too competitive or too concentrated?

(b) If the banking sector is concentrated, do all banks which meet minimum capital and management standards have freedom of entry? Does this freedom or restriction apply equally to domestic and foreign banks? If entry is restricted, what accounts for this? What is necessary to do in order to lessen barriers to entry?

(c) What is the potential for expanded use of letters of credit, credit cards, home mortgages, trade finance, and loan guarantees? What are the factors that block the expansion of these loans?

(d) Are banks allowed to operate in the so-called multipurpose banking? If so, do they do it through affiliates or as part of a holding? If banks operate as part of holdings, are prudential norms adequate so as to prevent excessive concentration of loans in firms within the holding? Do these prudential norms prevent excessive banks' exposures in particular economic activities or areas of the country? Do prudential norms allow for warning systems that flash possible over-indebtedness of the entire holding group? Are these prudential norms enforced in practice?

(e) In case banks do not operate in multipurpose banking, does the regulatory framework provide rules that limit banks from large exposures? Are there any rules against inside lending? Are these enforced in practice?

(f) What is the capacity of supervisory entities to provide sound supervision and regulation, including procedures to abide by generally accepted accounting standards, to perform audits and to divulge information to the public? Are supervisory entities free from political interference?

(g) How large and important are the financial entities that are not subjected to supervision and prudential regulation?

(h) What is the average maturity of short, medium and long-term loans?

(i) How high are banks' intermediation margins?

(j) Is it profitable for banks to launch special programs aimed at handling small size loans?

(k) Is the legal system expedient and reliable to order the execution of foreclosures in the event of non-repayment of loans?

(l) Are procedures that are to be followed in case of bank insolvency sound?

2. **Savings Mobilization:**

(a) What are the constraints that impede increased local savings mobilization?

(b) Are there any restrictions to financial entities allowed to engage in savings mobilization?

(c) Are there any restrictions for the offering of checking accounts and certificates of deposit?

(d) What is the average maturity of time deposits? Are interest rate deposits flexible enough to permit positive interest rates?

(e) Are there mechanisms of deposit insurance? Are they implicit or explicit?

3 **Capital Markets and Pension Funds:**

(a) What are the principal financial instruments -- private equity, government securities, bonds and other types of private debt -- offered in financial markets? Of all these, which is (are) the most important and dynamic?

(b) Is the capital market developing fast? If not, why?

(c) Can you pinpoint specific factors that prevent firms from going "public"? Is it because brokers and/or the government underprice issues? Or is it because there are tax disincentives against securities? Or is it because of inadequate laws and regulations?

(d) On the demand side, can you identify some factors that block the rapid expansion of capital markets?

(e) Does the regulatory framework protect investors against fraud and insider trading?

(f) Are requirements about disclosure of health of banks and corporations which trade stock and bonds comprehensive? Are information systems for disclosure reliable? Does it reach a wide audience?

(g) What is necessary to expand the availability of insurance, hedging, futures markets and other mechanisms for risk reduction?

(h) What is the relative importance of pension funds as vehicles to mobilize savings? What is the regulation for the investment of these funds? Is the regulation too restrictive or is it sound?

4 Policy:

(a) Are interest rates market-determined?

(b) How significant are targeted lines of credit? What are the sectors that are preferred? Have these lines been reduced over the years?

(c) Are government securities instruments of monetary policy, i e., vehicles for the implementation of open market operations? How are these traded? Do they offer competitive yields? Are banks forced to buy these securities?

(d) Are reserve requirements too high? Are there any other aspects of monetary policy that constitute obstacles for the liberalization of financial markets? Is the Central Bank free from political interference?

(e) Is the country committed towards the privatization of the state owned banks?

(f) Is the capital account open? If not, are there any economic constraints that retard the liberalization of the capital account? Are regulations too restrictive and impractical?

(g) Is there a trend for the "dollarization" of financial assets and liabilities? If so, do you foresee a negative impact for banks and other financial intermediaries?

(h) Is the current tax regime penalizing the development of financial markets?

(i) Does the current stock and flows of foreign debt constitute an obstacle or an opportunity for the expansion of financial markets?

5 **The Role of the Donor Community.**

What are the current and future programs of your organization in the financial sector? How might USAID assistance best complement your programs?

ANNEX B:

TABLES

TABLE 1 MACROECONOMIC INDICATORS

	BELIZE	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	NICARAGUA	PANAMA
GDP GROWTH RATE[1] (1991-1994)	18 1	21 5	19 6	16 8	14 1	1 9	31 1
INFLATION[1] (1994)	—	17 4	9 4	12 5	28 0	12 2	1 8
FOREIGN DEBT RATIOS (1993)[2]							
Face Value/Exports	67 0	148 0	128 0	136 0	328 0	2934 0	278 0
Debt Service Due/Exports	8 4	21 5	17 2	34 6	42 6	61 0	29 6
Level of Indebtedness	MILD	MODERATE	MILD	MILD	SEVERE	SEVERE	SEVERE
FISCAL DEFICIT[1] (as percentage of GDP)	—	4 6 (1994 est)	1 6 (1994 est)	1 6 (1994 est)	7 0 (1994 est)	8 3 (1994 est)	0 6 (1993)
REAL EXCHANGE RATE OF EXPORTS, 1994 est, (1990=100)[1]	—	101 9	82 8	84 6	125 9	103 2	—
TERMS OF TRADE, 1994 est (1980=100)[1]	—	95	57	96	126	55	106
M2/GDP (percent) [3]	—	37 0	30 5	23 3	28 1	10 8[4]	53 7
SAVINGS RATIO[5]	--	17 0	0 6	7 5	19 9	9 8	25 1

— information not available
[1] ECLAC, Preliminary Overview of the Latin American and Caribbean Economy, 1994
[2] World Bank, World Debt Tables, 1994-1995
[3] Data from International Monetary Fund, International Financial Statistics, 1993 M2 is the average of M2 in years 1991 and 1992 GDP is from 1992
[4] Statistics for M2 from Central Bank of Nicaragua, as cited in Economist Intelligence Unit Report, 1994-1995
[5] Coefficient of Gross Domestic Savings Source Anuario Estadístico de América Latina y el Caribe, CEPAL 1994

TABLE 1: MACROECONOMIC INDICATORS

	BOLIVIA	COLOMBIA	ECUADOR	PERU	VENEZUELA
GDP GROWTH RATE[1] (1991-1994)	16 5	16 2	15 2	18 5	11 5
INFLATION[1] (1994)	8 9	23 0	24 5	17 5	70 9
FOREIGN DEBT RATIOS (1993)[2]					
Face Value/Exports	489 0	164 0	366 0	477 0	208 0
Debt Service Due/Exports	70 7	29 2	50 8	76 0	23 6
Level of Indebtedness	SEVERE	MODERATE	SEVERE	SEVERE	MODERATE
FISCAL DEFICIT[1] (as percentage of GDP)	4 0 (1994 est)	0 2 (1993)	0 5 (1994 est)	1 4 (1993)	7 0 (1994 est)
REAL EXCHANGE RATE OF EXPORTS, 1994 est (1990=100)[1]	126 3	76 3	77 6	84 0	93 5
TERMS OF TRADE, 1994 est (1980=100)[1]	51	81	68	72	58
M2/GDP (percent) [3]	21 9[4]	17 4	8 8	11 1	27 1
SAVINGS RATIO[5]	7 8	20 3	21 4	18 9	18 9

[1] ECLAC, Preliminary Overview of the Latin American and Caribbean Economy, 1994
[2] World Bank, World Debt Tables, 1994-1995
[3] Data from International Monetary Fund, International Financial Statistics, 1993 M2 is the average of M2 in years 1991 and 1992 GDP is from 1992
[4] M2 is the average of M2 in years 1990 and 1991 GDP is from 1991
[5] Coefficient of Gross Domestic Savings Source Anuario Estadístico de América Latina y el Caribe, CEPAL 1994

TABLE 1: MACROECONOMIC INDICATORS

	ARGENTINA	BRAZIL	CHILE	PARAGUAY	URUGUAY
GDP GROWTH RATE[1] (1991-1994)	32 8	8 2	27 8	11 4	17 9
INFLATION[1] (1994)	3 6	1294 0	8 9	18 7	44 7
FOREIGN DEBT RATIOS (1993)[2]					
Face Value/Exports	438 0	307 0	157 0	96 0	302 0
Debt Service Due/Exports	95 9	40 4	22 4	15 6	29 9
Level of Indebtedness	SEVERE	SEVERE	MODERATE	MILD	SEVERE
FISCAL DEFICIT[1] (as percentage of GDP)	0 1 (1994 est)	0 3 (1993)	1 3 (1994 est)	0 2 (1993)	2 5 (1994 est)
REAL EXCHANGE RATE OF EXPORTS, 1994 est (1990=100)[1]	76 3	96 2	95 0	94 5	73 0
TERMS OF TRADE, 1994 est (1980=100)[1]	63	87	79	131	91
M2/GDP (percent) [3]	11 1	21 8[4]	28 2	23 2	38 4
SAVINGS RATIO[5]	18 2	17 3	21 5	10 2	12 4

1 ECLAC, Preliminary Overview of the Latin American and Caribbean Economy, 1994
2 World Bank, World Debt Tables, 1994-1995
3 Data from International Monetary Fund, International Financial Statistics, 1993 M2 is the average of M2 in years 1991 and 1992 GDP is from 1992
4 Statistics for M2 from Central Bank of Brazil, statistics for GDP from Instituto Brasileiro de Geografia e Estatística, both as cited in Economist Intelligence Unit Report, 1994-1995
5 Coefficient of Gross Domestic Savings Source Anuario Estadístico de América Latina y el Caribe, CEPAL 1994

TABLE 1: MACROECONOMIC INDICATORS

	BAHAMAS	BARBADOS	DOMINICAN REP	GUYANA	HAITI	JAMAICA	TRINID &TOBAG
GDP GROWTH RATE[1] (1991-1994)	0 1	5 0	14 3	32 5	-28 9	4 4	0 3
INFLATION[1] (1994)	—	-0 6	11 4	—	39 3 (1993)	32 6	6 4
FOREIGN DEBT RATIOS (1993)[2]	—						
Face Value/Exports		74 0	179 0	571 0	135 0	163 0	106 0
Debt Service Due/Exports		12 4	21 6	44 2	6 1	25 4	27 9
Level of Indebtedness		MILD	MODERATE	SEVERE	MILD	SEVERE	MILD
FISCAL DEFICIT[1] (as percentage of GDP)	—	—	0 9 (1994 est)	—	2 3 (1993)	—	—
REAL EXCHANGE RATE OF EXPORTS, 1994 est (1990=100)[1]	—	—	95 9	—	110 2 (1993)	—	—
TERMS OF TRADE, 1994 est (1980=100)[1]	—	—	57	—	68	—	—
M2/GDP (percent) [3]	44 2	55 9	19 3	59 5	37 2[4]	37 1	43 0
SAVINGS RATIO[4]	—	—	20 5	—	—	—	—

— information not available
[1] ECLAC, Preliminary Overview of the Latin American and Caribbean Economy, 1994
[2] World Bank, World Debt Tables, 1994-1995
[3] Data from International Monetary Fund, International Financial Statistics, 1993 M2 is the average of M2 in years 1991 and 1992 GDP is from 1992
[4] Coefficient of Gross Domestic Savings Source Anuario Estadístico de América Latina y el Caribe, CEPAL 1994

TABLE 2 FINANCIAL POLICY[1]

	BELIZE	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	NICARAGUA	PANAMA
INTEREST RATES MARKET DETERMINED	NO	YES[3]	YES	YES	YES	YES	YES
TARGETED LINES OF CREDIT	NONE	RISING	DECLINING	ELIMINATED	DECLINING	DECLINING	DECLINING
GOVERNMENT SECURITIES ACTIVELY USED FOR OPEN MARKET OPERATIONS	—	YES	YES	YES	NO	NO	N/A
LEVEL OF RESERVE REQUIREMENTS[2] (1994)							
-Demand Deposits	7%	30%	21%	17%	40%	10%	12%
-Time Deposits	7%	30%	17%	17%	40%	10%	5%
-For Currency Time Deposits	7%	100%	50%	N/A	100%	25%	0%
COMMITMENT TOWARDS PRIVATIZATION OF BANKS	N/A	NO	N/A[4]	NO	NO	NO	N/A
TREND FOR DOLLARIZATION	—	YES	YES[6]	NO	YES	YES	YES[5]
CAPITAL ACCOUNT OPEN	—	YES	YES	YES	YES	YES	YES
TAX REGIME PENALIZING FINANCIAL MARKETS	—	NOT SIGNIFICANTLY	NOT SIGNIFICANTLY	NOT SIGNIFICANTLY	NOT SIGNIFICANTLY	NO	NO

— information not available
N/A = not applicable
1 As of beginning of 1995
2 Westley 1995
3 Rates on some types of loans have not been liberalized
4 The privatization process of state banks has been completed There remains one development bank that is likely to remain in state hands
5 The U S dollar is the legal tender
6 A currency board reportedly will be in operation in mid-1996

TABLE 2 FINANCIAL POLICY[1]

	BOLIVIA	COLOMBIA	ECUADOR	PERU	VENEZUELA
INTEREST RATES MARKET-DETERMINED	YES	YES[3]	NO	YES	NO
TARGETED LINES OF CREDIT	—	RISING	DECLINING	ELIMINATED	—
GOVERNMENT SECURITIES ACTIVELY USED FOR OPEN MARKET OPERATIONS	YES	YES	NO[4]	NO	YES
LEVEL OF RESERVE REQUIREMENTS[2] (1994)					
-Demand Deposits	10%	41%	10%	9%	12%
-Time Deposits	4%	3%	10%	9%	12%
-For Currency Time Deposits	10%	5%	10%	42%	don t exist
COMMITMENT TOWARDS PRIVATIZATION OF BANKS	N/A[5]	YES	NO	YES	N/A[6]
TREND FOR DOLLARIZATION	YES	NO	NO	YES	YES
CAPITAL ACCOUNT OPEN	YES	NO	YES	YES	NO
TAX REGIME PENALIZING FINANCIAL MARKETS	NO	NOT SIGNIFICANTLY	YES	NO	—

— information not available
N/A = not applicable
[1] As of beginning of 1995
[2] Westley, 1995
[3] Except for loans from state banks
[4] Government has announced intention to develop this policy soon
[5] Process has been successfully completed
[6] As a result of the 1994 crisis 50% of total bank system assets has been taken over by the State As much as the government would like to privatize, current economic and political conditions make this process unviable

TABLE 2: FINANCIAL POLICY[1]

	ARGENTINA	BRAZIL	CHILE	PARAGUAY	URUGUAY
INTEREST RATES MARKET-DETERMINED	YES[3]	YES	YES[4]	YES	YES
TARGETED LINES OF CREDIT	DECLINING	DECLINING	DECLINING	DECLINING	NONE
GOVERNMENT SECURITIES ACTIVELY USED FOR OPEN MARKET OPERATIONS	N/A	YES	YES	NO	YES
LEVEL OF RESERVE REQUIREMENTS[2] (1994)					
-Demand Deposits	43%	100%	9%	30%	10%
-Time Deposits	3%	15%	4%	30%	4%
-For Currency Time Deposits	3%	don't exist	30%	30%	10%
COMMITMENT TOWARDS PRIVATIZATION OF BANKS	YES	NO	N/A	NO	NO
TREND FOR DOLLARIZATION	YES	NO	NO	YES	YES
CAPITAL ACCOUNT OPEN	YES	NO	NO	YES	YES
TAX REGIME PENALIZING FINANCIAL MARKETS	NOT SIGNIFICANTLY	YES	NO	—	NOT SIGNIFICANTLY

— information not available
N/A = not applicable
1 As of beginning of 1995
2 Westley, 1995
3 Ceilings apply for some loan rates Deposit rates are market-determined
4 Only deposit rates Loan rates are subject to ceilings based on average deposit rate

TABLE 2 FINANCIAL POLICY[1]

	BAHAMAS	BARBADOS	DOMINICAN REP.	GUYANA	HAITI	JAMAICA	TRINID &TOBAG
INTEREST RATES MARKET DETERMINED	YES	YES[3]	YES	YES	—	—	YES[4]
TARGETED LINES OF CREDIT	—	NONE	—	DECLINING	—	—	DECLINING
GOVERNMENT SECURITIES ACTIVELY USED FOR OPEN MARKET OPERATIONS	—	YES	—	NO	NO	—	YES
LEVEL OF RESERVE REQUIREMENTS[2] (1994)							
-Demand Deposits	20%	29%	20%	11%	—	25%	20%
-Time Deposits	15%	29%	20%	9%	—	25%	20%
-For Currency Time Deposits	0%	29%	0%	0%	—	22%	20%
COMMITMENT TOWARDS PRIVATIZATION OF BANKS	YES	NO	NO	YES	—	NO	YES
TREND FOR DOLLARIZATION	NO	NO	NO	YES	—	—	NO
CAPITAL ACCOUNT OPEN	—	NO	YES	—	—	—	—
TAX REGIME PENALIZING FINANCIAL MARKETS	NO	YES	NOT SIGNIFICANTLY	—	—	—	YES

— information not available
1 As of beginning of 1995
2 Westley, 1995
3 Except for loans from the Agricultural Development Bank
4 Except for loans from state banks

TABLE 3 BANKING SECTOR

	BELIZE	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	NICARAGUA	PANAMA
BARRIERS TO ENTRY	NO	YES	NO	NO	NO	NO	NO
HANDLING OF SMALL LOANS BY PRIVATE COMMERCIAL BANKS	—	NO	NO	NO	NO	NO	—
MULTIPURPOSE BANKING	—	YES	NO	NO	NO	YES	YES
AVERAGE MATURITY OF LOANS	—	SHORT TERM ~180 DAYS	MEDIUM TERM >1 YEAR	SHORT TERM	SHORT TERM ~60 DAYS	SHORT TERM ~45 DAYS	SHORT TERM ~90 DAYS
AVERAGE MATURITY OF DEPOSITS	—	SHORT TERM	SHORT TERM 90-180 DAYS	SHORT TERM	SHORT TERM ~180 DAYS	SHORT TERM ~90 DAYS	SHORT TERM ~90 DAYS
INTERMEDIATION MARGINS	—	HIGH	LOW	HIGH	HIGH	HIGH	—
CAPITAL ADEQUACY STANDARDS	—	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	ADEQUATE	INADEQUATE
PROVISIONING FOR BAD LOANS	—	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	INADEQUATE	ADEQUATE
SUPERVISORY SYSTEM NEED FOR IMPROVEMENT	NONE	MILD	MILD	MAJOR	MAJOR	MILD	MAJOR
PORTION OF FINANCIAL ENTITIES NOT SUBJECT TO SUPERVISION	—	SIGNIFICANTLY LARGE	INSIGNIFICANT	LARGE	SIGNIFICANTLY LARGE	—	—
LEGAL AND JUDICIARY SYSTEM	—	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	—
SOUND PROCEDURES FOR BANK INSOLVENCY	—	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	—
DEPOSIT INSURANCE	—	IMPLICIT	IMPLICIT[1]	EXPLICIT	IMPLICIT	IMPLICIT	NONE

— information not available

[1] An explicit system to protect small depositors will be implemented soon

TABLE 3 BANKING SECTOR

	BOLIVIA	COLOMBIA	ECUADOR	PERU	VENEZUELA
BARRIERS TO ENTRY	—	NO	YES[1]	NO	NO
HANDLING OF SMALL LOANS BY PRIVATE COMMERCIAL BANKS	NO	—	NO	NO[2]	YES
MULTIPURPOSE BANKING	YES	YES	YES	YES	YES
AVERAGE MATURITY OF LOANS	SHORT TERM ~60 DAYS	—	SHORT TERM ~90 DAYS	SHORT TERM ~90 DAYS	SHORT TERM ~90 DAYS
AVERAGE MATURITY OF DEPOSITS	SHORT TERM <90 DAYS	—	SHORT TERM <120 DAYS	SHORT TERM <120 DAYS	SHORT TERM <90 DAYS
INTERMEDIATION MARGINS	HIGH	HIGH	HIGH	HIGH	HIGH
CAPITAL ADEQUACY STANDARDS	INADEQUATE	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE
PROVISIONING FOR BAD LOANS	INADEQUATE	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE
SUPERVISORY SYSTEM NEED FOR IMPROVEMENT	MILD	MILD	MILD/MAJOR	MILD	MAJOR
PORTION OF FINANCIAL ENTITIES NOT SUBJECT TO SUPERVISION	LARGE	—	—	SMALL	SMALL
LEGAL AND JUDICIARY SYSTEM	INADEQUATE	—	INADEQUATE	INADEQUATE	INADEQUATE
SOUND PROCEDURES FOR BANK INSOLVENCY	ADEQUATE[3]	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE
DEPOSIT INSURANCE	IMPLICIT	EXPLICIT	—	IMPLICIT	EXPLICIT

— information not available
[1] Government tries to discourage new entrants and pressures existing banks to raise capital
[2] Reportedly only one commercial bank is involved in this
[3] Not enforced

TABLE 3 BANKING SECTOR

	ARGENTINA	BRAZIL	CHILE	PARAGUAY	URUGUAY
BARRIERS TO ENTRY	NO	YES	YES	NO	NO
HANDLING OF SMALL LOANS BY PRIVATE COMMERCIAL BANKS	NO	—	NO	NO	NO
MULTIPURPOSE BANKING	YES	YES	YES	NO	—
AVERAGE MATURITY OF LOANS	SHORT TERM ~90 DAYS	SHORT TERM ~90 DAYS	SHORT TERM[1]	SHORT TERM	SHORT TERM
AVERAGE MATURITY OF DEPOSITS	SHORT TERM ~90 DAYS	SHORT TERM ~30 DAYS	MEDIUM TO LONG TERM	SHORT TERM	SHORT TERM
INTERMEDIATION MARGINS	HIGH	—	LOW	HIGH	HIGH
CAPITAL ADEQUACY STANDARDS	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	ADEQUATE
PROVISIONING FOR BAD LOANS	INADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	ADEQUATE
SUPERVISORY SYSTEM NEED FOR IMPROVEMENT	MILD/MAJOR	MAJOR	VERY MILD	MAJOR	NONE
PORTION OF FINANCIAL ENTITIES NOT SUBJECT TO SUPERVISION	INSIGNIFICANT	INSIGNIFICANT	INSIGNIFICANT	—	INSIGNIFICANT
LEGAL AND JUDICIARY SYSTEM	INADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	INADEQUATE
SOUND PROCEDURES FOR BANK INSOLVENCY	INADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	N/A
DEPOSIT INSURANCE	EXPLICIT	—	EXPLICIT	IMPLICIT	NONE

— information not available
N/A = not applicable
[1] Banks, though, have resources to offer medium and long term loans There are, however, very few takers of these products

TABLE 3 BANKING SECTOR

	BAHAMAS	BARBADOS	DOMINICAN REP	GUYANA	HAITI	JAMAICA	TRINID &TOBAG
BARRIERS TO ENTRY	NO	YES	NO	NO	—	—	—
HANDLING OF SMALL LOANS BY PRIVATE COMMERCIAL BANKS	NO	NO	NO	NO	—	NO	NO
MULTIPURPOSE BANKING	YES	YES	YES	YES	—	YES	YES
AVERAGE MATURITY OF LOANS	MEDIUM TERM	MEDIUM TO LONG TERM[1]	SHORT TERM	SHORT TERM ~90 DAYS	—	—	MEDIUM TO LONG TERM[1]
AVERAGE MATURITY OF DEPOSITS	SHORT TERM	—	SHORT TERM	SHORT TERM ~90 DAYS	—	—	—
INTERMEDIATION MARGINS	—	HIGH	HIGH	—	—	HIGH	HIGH
CAPITAL ADEQUACY STANDARDS	ADEQUATE	INADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	ADEQUATE	ADEQUATE
PROVISIONING FOR BAD LOANS	ADEQUATE	INADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE	ADEQUATE	ADEQUATE
SUPERVISORY SYSTEM NEED FOR IMPROVEMENT	NONE	MILD	MILD[2]	MAJOR	MAJOR	MILD	VERY MILD
PORTION OF FINANCIAL ENTITIES NOT SUBJECT TO SUPERVISION	—	—	LARGE	LARGE	LARGE	—	LARGE
LEGAL AND JUDICIARY SYSTEM	—	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	—	INADEQUATE
SOUND PROCEDURES FOR BANK INSOLVENCY	—	ADEQUATE	INADEQUATE	—	—	—	ADEQUATE
DEPOSIT INSURANCE	NONE	IMPLICIT	IMPLICIT	NONE	—	—	EXPLICIT

— information not available
[1] Banks do offer significant volumes of medium (average maturity 2-5 years) and long (average maturity 7-10 years) term loans
[2] Bank supervision does suffer from major political interference

TABLE 4 CAPITAL MARKETS

	BELIZE	COSTA RICA	EL SALVADOR	GUATEMALA	HONDURAS	NICARAGUA	PANAMA
DEVELOPMENT OF CAPITAL MARKETS[1]	NONE	SLOW	SLOW	SLOW	NONE	NONE	SLOW
PRINCIPLE TYPE OF FINANCIAL INSTRUMENT	—	GOVERNMENT DEBT	GOVERNMENT DEBT	GOVERNMENT DEBT	GOVERNMENT DEBT	NONE	GOVERNMENT DEBT
CORPORATE EQUITY ACTIVELY TRADED	—	NO	NO	NO	NO	NO	NO
LAWS AND REGULATIONS	—	INADEQUATE	ADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE
INVESTORS REASONABLY PROTECTED	—	NO	YES	NO	NO	NO	NO
AVAILABILITY OF RISK REDUCTION MECHANISMS	—	NO	NO	NO	NO	NO	NO
INFORMATION DISCLOSURE REQUIREMENTS	—	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE	INADEQUATE
PENSION FUNDS PROMOTE EXPANSION OF CAPITAL MARKETS	—	NO	NO	NO	NO	NO	NO

— information not available

[1] In terms of total market capitalization and volume of daily trading

TABLE 4 CAPITAL MARKETS

	BOLIVIA	COLOMBIA	ECUADOR	PERU	VENEZUELA
DEVELOPMENT OF CAPITAL MARKETS[1]	VERY SLOW	FAST	VERY SLOW	FAST	VERY SLOW
PRINCIPLE TYPE OF FINANCIAL INSTRUMENT	GOVERNMENT SECURITIES	GOVERNMENT BONDS	GOVERNMENT BONDS	EQUITY	GOVERNMENT SECURITIES
CORPORATE EQUITY ACTIVELY TRADED	NO	YES	NO	YES	NO
LAWS AND REGULATIONS	INADEQUATE	ADEQUATE	ADEQUATE	ADEQUATE	INADEQUATE
INVESTORS REASONABLY PROTECTED	NO	YES	YES	NO	NO
AVAILABILITY OF RISK REDUCTION MECHANISMS	NO	YES	NO	NO	NO
INFORMATION DISCLOSURE REQUIREMENTS	NO	YES	YES	YES	NO
PENSION FUNDS PROMOTE EXPANSION OF CAPITAL MARKETS	NO	YES	NO	NO	NO

[1] In terms of total market capitalization and volume of daily trading

TABLE 4 CAPITAL MARKETS

	ARGENTINA	BRAZIL	CHILE	PARAGUAY	URUGUAY
DEVELOPMENT OF CAPITAL MARKETS[1]	VERY SLOW	SLOW	FAST	N/A	SLOW
PRINCIPLE TYPE OF FINANCIAL INSTRUMENT	GOVERNMENT T BILLS	GOVERNMENT SECURITIES	GOVERNMENT BONDS	N/A	GOVERNMENT SECURITIES
CORPORATE EQUITY ACTIVELY TRADED	NO	YES	YES	N/A	NO
LAWS AND REGULATIONS	INADEQUATE	ADEQUATE	ADEQUATE	N/A	INADEQUATE
INVESTORS REASONABLY PROTECTED	NO	NO	YES	N/A	NO
AVAILABILITY OF RISK REDUCTION MECHANISMS	NO	YES	YES	N/A	NO
INFORMATION DISCLOSURE REQUIREMENTS	INADEQUATE	ADEQUATE	ADEQUATE	N/A	NO
PENSION FUNDS PROMOTE EXPANSION OF CAPITAL MARKETS	NO	NO	YES	N/A	NO

N/A = not applicable

[1] In terms of total market capitalization and volume of daily trading

TABLE 4 CAPITAL MARKETS

	BAHAMAS	BARBADOS	DOMINICAN REP	GUYANA	HAITI	JAMAICA	TRINID &TOBAG
DEVELOPMENT OF CAPITAL MARKETS[1]	N/A	SLOW	VERY SLOW	N/A	N/A	—	SLOW
PRINCIPLE TYPE OF FINANCIAL INSTRUMENT	N/A	GOVERNMENT SECURITIES	—	N/A	N/A	—	GOVERNMENT SECURITIES
CORPORATE EQUITY ACTIVELY TRADED	N/A	NO	NO	N/A	N/A	NO	NO
LAWS AND REGULATIONS	N/A	ADEQUATE	INADEQUATE	N/A	N/A	—	INADEQUATE
INVESTORS REASONABLY PROTECTED	N/A	YES	NO	N/A	N/A	—	NO
AVAILABILITY OF RISK REDUCTION MECHANISMS	N/A	NO	NO	N/A	N/A	NO	NO
INFORMATION DISCLOSURE REQUIREMENTS	N/A	ADEQUATE	INADEQUATE	N/A	N/A	—	INADEQUATE
PENSION FUNDS PROMOTE EXPANSION OF CAPITAL MARKETS	N/A	—	NO	N/A	N/A	—	NO[2]

— information not available
N/A = not applicable

[1] In terms of total market capitalization and volume of daily trading

[2] In the near future, this is a possibility because pension funds are growing fast

LIST OF PEOPLE INTERVIEWED

Norys Aguirre Zambrano, former president of FOGADE, Venezuela
Humberto Arbulú-Neira, International Monetary Fund
Bill Armstrong, Inter American Development Bank
Michael Atkin, Institute of International Finance
Carlos Bianchetti, Banco Francés, Argentina
Arnoldo Camacho, INCAE, Costa Rica
Edna Camacho Mejía, Academia de Centro América
Mauricio Carrrizosa, The World Bank
Guillermo Collich, Inter American Development Bank
Marilú Cortés, The World Bank
José Luis Daly, Citicorp Venezuela
Juan Luis Daly, J.L Daly Management Consultants, Inc , Miami
Oscar de la Cuadra, Forecast, Chile
Enrique de la Piedra, International Monetary Fund
Santiago Edwards, Administradora de Fondos de Pensiones Provida S A , Chile
Francisco J Faraco, Francisco J. Faraco R y Asociados, Venezuela
Ernesto Feldman, International Monetary Fund
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César Fort, The World Bank
Vicente Fretes-Cilbis, The World Bank
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Luis Liberman, Banco Interfin, Costa Rica
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Walter Ness, Universidad Católica de Rio de Janeiro, Brazil
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Cristián Salinas, Banco Central, Chile
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Kim Staking, Inter American Development Bank
Bob Traa, International Monetary Fund
Thelmo Vargas Madrigal, Academia de Centro América
Waldo Vergara, Inter American Development Bank
Jesse W. Wright, Inter American Development Bank
Mayra Zermeño, The World Bank

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