The Political Challenges of Economic Reforms in Latin America

Strengthening Banking Systems

A key factor in reducing macroeconomic volatility is strengthening domestic banking systems. The recent crises in Asia have shown that a poorly regulated and supervised banking system can become exceedingly overextended and vulnerable, especially during a period of rapid economic expansion. In an era of mobile international capital, such vulnerability can lead to a rapid financial collapse. The Mexico experience in 1994—95 also demonstrated that an unhealthy banking sector can seriously aggravate a crisis that is triggered by a sharp depreciation in the currency. Whether a banking crisis triggers economic recession or aggravates a recession that is set off by other factors, it is clear that a fragile banking system contributes significantly to macroeconomic volatility. Conversely, a sound banking system that can absorb shocks—in particular, a sudden weakening of asset quality and/or a loss of deposits due to a currency crisis—is necessary to reduce the frequency and amplitude of macroeconomic fluctuations.

Many Latin American countries have been working to reform and improve their banking systems. Financial markets have been liberalized so that lending and deposit rates are set by market forces and competitive pressures are at play. In many countries, public banks have been closed or privatized. New laws and regulations are in place that require banks to adhere to the standards of the Basle Accords—although many argue that even higher standards, especially with respect to capital adequacy ratios, are needed in Latin America. In most countries, however, the agencies responsible for the supervision and enforcement of these new laws and regulations are weak. Accounting standards are low. Judicial system support for the superintendent is fragile. In many countries, the quality of bank capital is low, asset classifications are not sufficiently conservative, and consolidation of off-shore activities remains problematic. As a result, some banking systems in the region remain vulnerable to economic shocks, and their weakness would increase the severity of any downturn.

The banking systems in Latin America[9] would be strengthened by further progress on the following fronts:

1. Opening up the banking sector to foreign participation. In much of Latin America, this is already a reality, not an option. In Argentina, for example, foreign banks have bought controlling interest in a large share of the banking system. Most recently, a Dutch bank bought Brazil's fourth largest bank. Such foreign participation has many advantages: it increases competitive pressure; it brings new operational technologies; it creates a bulwark against the traditional forms of government intervention in credit allocation; and it means that the foreign banks will be subject to the supervisory authorities from their home countries.[10] A substantial foreign bank presence may therefore contribute to the stability of the system; depositors are less likely to lose confidence in a foreign bank with deep pockets and the oversight of its home country authority. Foreign participation is not, however, a panacea. In some countries there is evidence that the quality of the loan portfolios of foreign banks is not better than that of local banks, and often the foreign

banks only seek involvement in limited or specialized financial markets. And, in any case, in most countries there are likely to be political limits to the tolerance for foreign control of such a critical sector. These political limits may vary widely among countries. At one extreme, Argentina has accepted that foreign banks will play the dominant role. Nationalistic sentiments may preclude such a policy in some countries.[11] In most, however, a mixed system involving some foreign banks and a set of large domestic banks is evolving.

2. Building competent and independent superintendencies of banks. Even when modern laws and regulations are in place, they can only be enforced by a competent superintendency that will not yield to political pressures for excessive "regulatory forbearance."[12] In creating such an institution, the following measures may be useful.[13] First, to ensure adequate budget resources so that the institution can pay sufficiently high salaries and avoid the vagaries of legislative appropriations, a transaction tax on banks can be earmarked for support of the superintendency. Second, to increase the political autonomy of the superintendency, the tenure of the superintendent and the supervisory board should not coincide with that of the country's chief executive. Furthermore, a superintendent should be protected from removal except by the judicial branch for cause. Third, the superintendency should be placed within the governmental structure in order to strengthen its prestige, professional standards, and sense of independence. The best placement will vary among countries. In countries in which the central bank has a reputation for high professional standards, the superintendency might be established within the central bank. In other countries, it may be best to make the superintendent fully autonomous. Fourth, every effort should be made to build up the professional linkages between the national superintendency and foreign banking authorities. Such linkages will be needed to allow supervision of overseas branches of domestic banks, which is crucially important so that banks can be evaluated on a consolidated basis. All of these measures will contribute to stronger supervision. But it should be recognized that strong supervision is a necessary but not sufficient condition to prevent a banking crisis. In a strong boom-bust cycle, even well-supervised and well-managed banks can get into trouble, and no amount of supervision can compensate for bad macroeconomic management. Furthermore, a strong superintendent can be only one element in maintaining a reasonable balance of political and economic power within a society. Nevertheless, a healthy banking system requires a strong and competent superintendency, and any delays in creating such capacity can be very costly.

3. Complementing public supervision with market mechanisms to penalize bad bank performance. Market mechanisms that help to monitor bank behavior, reward good performance, and penalize poor performance have a distinct advantage: they do not depend on the institutional competence or the political independence of the supervisory authorities. Possible mechanisms have been pioneered in Chile and Argentina. Perhaps most important, both countries have greatly increased the transparency of their banking systems. In Chile, auditors review banks three times a year, and their summary ratings are published in newspapers. Argentina has created and disseminated a detailed computerized database on bank borrowers. It has also required banks to issue subordinated debt, and the price of these debt instruments in the secondary market

becomes a barometer of each bank's health. It remains to be seen which mechanisms will prove to be most effective. However, experience to date in the region suggests that the rating of banks by private credit agencies has thus far been relatively ineffective in increasing transparency and promoting market discipline. This may reflect the poor quality of accounting and hence inadequate information about banks, and these problems will plague virtually all of the market mechanisms. It should also be recognized that, if depositors count on blanket deposit insurance and shareholders count on the government's protection against loss, none of these market mechanisms work well. In short, the mechanisms can complement but not substitute for other measures discussed here.

4. Developing clear laws and transparent processes for the exit of insolvent banks and bankruptcy of firms.[14] A healthy banking system—indeed, a healthy market economy—needs mechanisms for closing down failed businesses.[15] Such mechanisms are a necessary part of Schumpeter's "creative destruction" of capitalism. Without such mechanisms, an economy's capacity to ensure continuing best use of productive assets is severely hampered. And yet few Latin American countries have made progress in establishing bankruptcy laws and in developing the administrative and judicial capacities to enforce them.[16] As a result, loans to comatose firms remain on the books of otherwise healthy banks, restricting their capacity for new lending. Because of the lack of good processes for the resolution of insolvent banks, it is much harder for supervisory authorities to intervene. Consequently, after a banking crisis, the system can remain unhealthy for years. This seems to be the case in Mexico. The crisis that started in 1994 is, in an important sense, not over. Bank restructurings have not been completed because of weaknesses in the judicial system for dealing with restructuring issues and because of political debate over the terms of bank resolutions. As a result, domestic banks in Mexico can provide very limited new lending, and this impedes economic recovery. The same fate is likely to await the Korean banking system unless resolutions of bankruptcies of firms and of banks can be undertaken quickly.

5. Establishing limits on insurance for depositors and enforcing bank shareholder losses. The tradition in much of Latin America is that governments bail out banks that become insolvent. This usually has involved full compensation for all depositors, and it has often allowed bank owners to avoid significant losses of capital. These traditional practices create a very real moral hazard: depositors need not monitor the soundness of their banks; and, most important, bank owners and managers can take excessive lending risks.[17] The consequent risks to the public treasury are huge. In the wake of a banking crisis involving widespread insolvencies, the fiscal costs of bailouts can amount to a significant share of GDP. This often forces governments to run fiscal deficits that ultimately can be financed only by a substantial inflation tax. To avoid these problems, it is a priority throughout the region to enact new laws and associated regulations that clarify and limit deposit insurance and that set procedures for the rapid resolution of insolvencies under which bank shareholders lose their capital.

Further strengthening banking systems in Latin America by implementing the above measures presents an important political challenge. The community of bank owners constitutes a politically powerful group within any country—developed or developing. If bank owners cannot be persuaded to support reforms in the system, their united opposition will be difficult to overcome. Given the potential political obstacles, how can Latin American policy-makers pursue this remaining agenda for banking sector reform?

Before considering political tactics, two general points merit mention. First, maintaining a reasonably stable macroeconomic environment is almost certainly a prerequisite for further improving the banking system. Low inflation contributes to the transparency of the entire financial system, helping banks determine the health of current and potential borrowers. A low-inflation environment with prospects for reasonable growth is necessary to attract significant investment by foreign banks. Most important, relatively low real interest rates can do more to strengthen the health of the economy and hence the banking system than anything else, making them more amenable to stronger supervision and to foreign competition. Second, there are no easy and "quick fixes." Building up elements of an efficient financial market infrastructure, such as a competent superintendency and better accounting practices, takes time. Good banking system management is hard even in developed countries, as illustrated by the massive savings-and-loan debacle in the United States and by the continuing troubles in Japan's financial sector. In any case, the health of the banking system depends on the health of the underlying economy, which is fragile during periods of dramatic reforms. Policy-makers in developing and transitional economies therefore should understand that strengthening banking systems is a "long march" during which setbacks and crises should be expected.

Nevertheless, past experience suggests some useful lessons and guidelines for making progress on the above-outlined agenda:

1. A banking crisis is itself the moment of greatest opportunity for introducing reforms. This was the experience in Chile in 1982, in Argentina in 1990 and 1994, and in El Salvador in 1997.[18] When crisis hits and the need for reform is acutely evident, it is most feasible to obtain Congressional approval for new laws to underpin improvements in the system. Policy-makers must act quickly to seize the moment. To be able to do so, it may be wise to do the necessary technical work in advance—for example, to draft any necessary new laws in a technical committee while waiting for the political opportunity to seek their approval. Following a crisis, political support for strict enforcement of the new laws and regulations may persist for years. This has been the case in Chile.

2. Policy-makers should make use of the competitive pressure from foreign banks to win support for stronger domestic regulation and supervision. Given the internationalization of banking, a strong domestic regulatory framework and a credible supervisory capacity are necessary for domestic banks to be competitive. An analogy to airline supervision is useful: If customers can choose between a domestic airline for which safety is supervised by a weak domestic agency and a foreign airline for which safety supervision is done by a well-regarded and competent agency, which will they chose? In the same way, depositors will choose banks that can boast good regulation and supervision. Domestic bank owners should therefore be persuaded that, given the presence of foreign banks within the national financial system, they cannot survive unless they subject themselves to good

supervision. This is how policy-makers should "sell" the need for a strong and independent superintendency.

3. Policy-makers should take advantage of international institutions and their associated norms as allies for reform and for the enforcement of good policies. The Basle Committee, the Bank for International Settlements, the supervisory authorities in OECD countries, the IMF, the World Bank, and the Inter-American Development Bank can provide standards for and/or technical assistance in the design of better regulations and institutions. In some circumstances, these institutions can also be useful in persuading political and business leaders of the need for reform. Moreover, the international norms and the institutions that propagate and monitor them can become important allies in the enforcement of good laws and regulation. As the process of internationalization expands, domestic banks and supervisory authorities become increasingly embedded within a structure that reinforces good national policies and practices, and this makes enforcement more feasible.

4. In this policy area, coalition-building within the relatively limited set of political and economic elites can be sufficient to achieve change. Political support must be created among the leaders of the business (both bank and non-bank) community. In seeking support for reforms, policy-makers' natural allies are the relatively strong banks that can expect to survive under the rigors of international competition and good supervision and also the relatively strong firms that expect to be their clients. For this reason, reformers may need to "divide and conquer" the banking community. In the non-bank business community, a fairly broad alliance may be possible: large firms that already enjoy access to bank lending can expect to gain from lower spreads and lending rates; and firms that do not enjoy sufficient access can hope to gain it. The losers and hence opponents of reforms will be the firms whose relative lack of creditworthiness would be penalized by a more efficient banking system.

5. The basic elements of the system should be embedded in law—not only in regulation. Putting the foundations of the banking system, including the superintendency, into law approved by the legislature reduces the likelihood of reversals and enhances the long-term credibility of the system. Nevertheless, some useful actions—for example, strengthening regulations governing asset classifications—may involve only a "stroke of the pen" within the executive branch rather than legislative action. Even in the absence of crisis, a minister of finance or a central bank president may be able to make some progress by using the strength of the office to push through such regulatory change. Such incremental steps in the right direction should be pursued whenever an opportunity to do so arises.