Emerging Markets Forum

Financial Markets in Latin America

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Discussion Draft

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1. Introductory remarks

Financial system development makes important contributions to economic performance. A well functioning financial system channels financial resources and capital to productive use, and spurs economic growth. In turn, excessive regulation and government intervention can severely interfere with the proper functioning of financial institutions.

During many years, and through the 1990s, limited access to bank credit and uncertainty about macroeconomic and financial stability imposed serious constraints on Latin America's growth and contributed to high volatility. As these facts became increasingly recognized, many countries of the Western Hemisphere took steps to reform, and liberalize their financial systems, including reductions in government controls. Financial liberalization spurred credit growth during the early part of the 1990s, but bank lending slowed after a series of banking crises in the mid-1990s. Subsequently, bank restructuring and regulatory reforms were introduced to help strengthen banking systems in a number of countries. Such reforms have generally been successful in increasing financial intermediation and in improving economic performance. In the process of reform, however, there was a need to attain a balance between appropriate liberalization and adequate government prudential and policy regulation concurrently. Failure to accomplish a proper balance has lead to financial crises such as those that recently hit several countries.

Investment and finance also have become a global matter, and, for developing and developed economies alike, countries must integrate their domestic financial systems into the emerging global system. With an eye on that ultimate objective, many countries are coordinating their liberalization and integration efforts with neighboring countries. The best-known examples of sub-regional cooperation and integration efforts are the Asia-Pacific region and the EU. A number of institutions in the Americas are also supporting the move toward financial integration, although at much earlier stages of the process.

This presentation seeks to explain how financial sector developments have been related to the structural characteristics of Latin American economies, and to highlight some of the financial sector failures that have affected Latin America's macroeconomic performance. The analysis presented here provides evidence of the need to strengthen Latin America's efforts to ensure financial system soundness and promote deeper financial intermediation.

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[1] This background paper was prepared as background for the Forum of Emerging Economies (Jakarta, September 2006). It constitutes a survey of existing material, produced by a number of institutions, particularly the IMF, IADB, INTAL, CAF, and the World Bank. Specifically, this documents draws heavily on the following works: Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience since the Early 1990s. Anoop Singh, et. al. (International Monetary Fund, Occasional Paper #238, 2005); Beyond Borders: The New Regionalism in Latin America, Inter-American Development: Bank, (2003); Recovering Growth in Latin America: Trade, Productivity and Social Inclusion, RED, CAF, (2005). Important comments made by Harinder Kohli and Graciana del Castillo have been incorporated into the text. However, any mistakes and misquotes are the responsibility of the author of this note.

2. Key Characteristics of Latin American Financial Systems

a. Market Structure

Latin American financial systems are largely bank-based, with security markets mostly small and illiquid. Banking systems are highly concentrated, intermediation margins are high, and the scale of bank lending is low relative to economic activity. Banks have had a comparative advantage in the collection and processing of information that is central to financial intermediation, precluding market based finance.

Table #1

Indicators of Capital Market Size, 2004

(US$ trillion)

	Stock Market Capitalization	Public Debt	Private Debt	Bank Deposits	Total Assets	% of GDP	GDP
World	37200	23100	34900	49600	144700	354	40900
European Union	9300	7300	12000	22100	50700	413	12300
USA	16300	5500	17000	7900	46700	398	11700
Japan	5900	6900	2300	7200	22200	476	4700
Emerging Markets	5100	2300	1300	8100	16900	171	9900
Asia	3500	1000	920	5700	11200	251	4500
Latin America	**850**	**750**	**220**	**920**	**2700**	**136**	**2000**
Share of LA (% total)	**2.2**	**3.2**	**0.6**	**1.9**	**1.8**		**4.9**

38

Sources: BIS, IMF, Stock Market Federation

In most Latin American countries, the private sector's use of bond and equity markets to raise finance remains limited, relative to its recourse to banks, although, in some countries, pension reforms have begun to encourage broader capital market development. Despite their prominence, banking systems remain relatively small compared with GDP, and the depth of intermediation is particularly low. Deposit-to-GDP ratios are less than 50 percent, compared with typical ratios of 90 percent in East Asian emerging markets.[2] Moreover, bank credit represents only a fraction of bank assets. In most countries, excepting Chile and Ecuador, lending represents no more than a third of bank assets. Again excepting Chile, the ratio of bank credit to economic activity remains much smaller than in the bank based financial systems of the advanced economies of the euro area and Japan, or of the emerging market economies of Asia. Furthermore, lending is directed tom a large extent to consumer

[2] Even though financial intermediation rose in recent years, it took Mexico 5 years after the 1994 crisis before bank intermediation was reactivated and then loans were mostly for consumption. 10 years latter, consumer credit is less than 4% of GDP (as compared to 8% in Chile and 17% in the US). In Uruguay, 4 years after the banking crisis bank lending is short term and basically for consumption.

credit, rather than investment, which tends to be financed from retained earnings or non-bank and foreign sources.

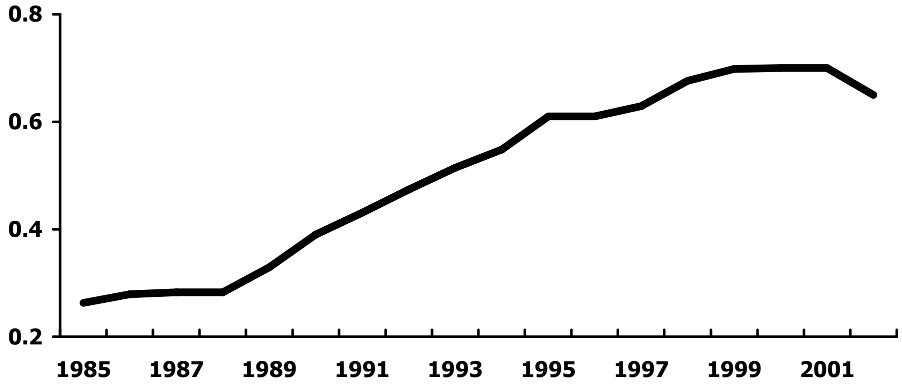
Table #2: Bank Deposits (US dollars and percent of GDP

	US$	%GDP
World	49600	121
European Union	22100	180
USA	7900	68
Japan	7200	153
Emerging Economies	8100	82
Asia	5700	127
Latin America	**920**	**46**

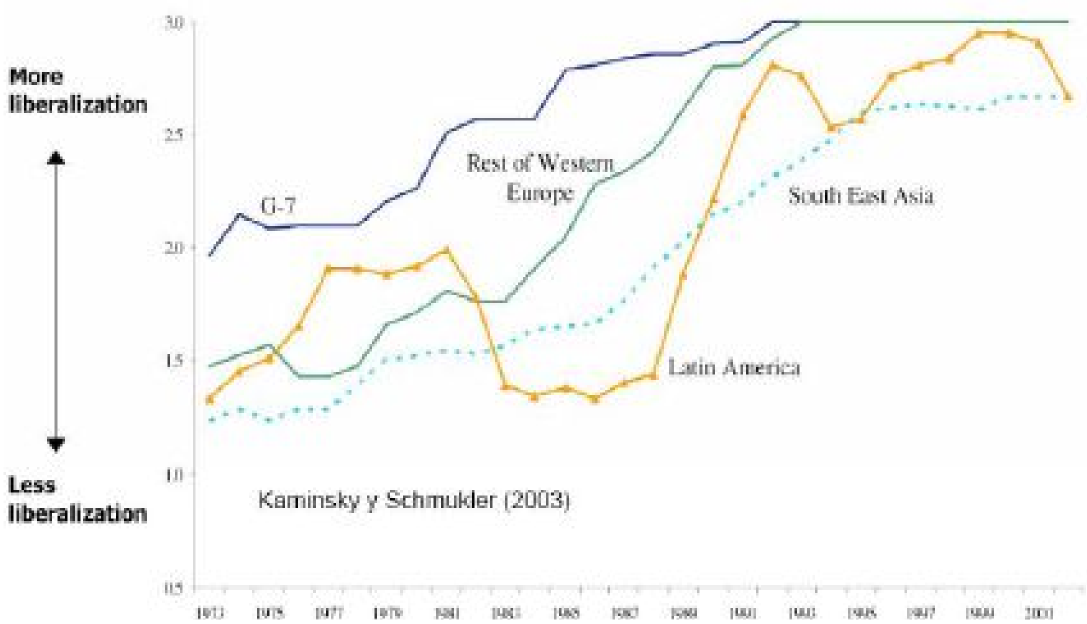
Source: IMF, Global Financial Stability Report, April 2006

The pattern of credit growth in Latin America has been marked by boom-bust cycles. Credit growth was particularly rapid in the early 1990s, but collapsed in many cases after banking crises in the mid-1990s and has since remained subdued. Argentina, Brazil, and Mexico all follow this pattern, although in Mexico the growth of other sources of financial intermediation has partly compensated for the lack of bank activity. Chile has managed to achieve a more even pattern of credit growth, because of its longer track record of macroeconomic stability and earlier financial sector reform.

Latin America:Financial Liberalization
(index 0 to 1)



Financial Liberalization
(including current account, and domestic financial markets),



Over this period, a rising share of bank balance sheets has been absorbed by government securities. During the second half of the 1990s, after serious banking crises, many banks in Latin America shed nonperforming loans and obtained in exchange, sizable portfolios of government bonds. For public banks, this typically occurred through restructuring, with bad credits being replaced by government securities— for example, in Mexico after the 1994 banking crisis. In the private sector, this shift was often a reaction to experience with high default rates on lending to households and corporations and to a tightening of supervisory standards after setbacks to stabilization and reforms in the mid-1990s. As banks shared in the costs of these crises, they sought to hold significant amounts of high-yielding, apparently safer government bonds. For example, Argentine banks' holdings of such bonds more than doubled in 1995; and in Brazil, about a third of banks' assets were invested in government bonds by 2000.

The process of bank restructuring that occurred during the 1990s led to rising foreign ownership of Latin American banking systems. During this process, legal and regulatory limitations on the activities of foreign banks were relaxed or eliminated in most countries. Foreign banks gained market shares, mostly by taking control of domestic banks in need of fresh capital and new management rather than opening new institutions. In Brazil, for example, foreign banks grew from an insignificant presence in the mid-1990s to hold one-fifth of deposits and provide one-fourth of credit by the end of 2000. In Argentina, Chile, Mexico, Paraguay, Peru, and Venezuela, foreign banks owned more than half of banking-system assets by 2000 (Table 3).

Table #3: Selected Latin American Countries: Structure of Banking Systems

	Argentina	Brazil	Chile	Colombia	Ecuador	Mexico	Paraguay	Peru	Uruguay	Venezuela
Institutions										
Number of banks	71	135	28	32	40	35	22	15	23	39
					(In percent)					
Concentration—Top 10 banks										
Share of total assets	62	70	76	67	82	95	79	95	87	81
Share of total deposits	71	77	78	68	79	90	79	96	85	36
Share of total credit	66	70	80	65	78	93	59	94	88	64
Foreign bank participation										
Number of banks1	28	27	18	11	…	20	17	12	16	21
					(In percent)					
Share of total assets	54	28	60	21	…	82	81	64	35	68
Share of total deposits	48	21	47	20	…	82	86	62	34	67
Share of total credit	46	25	45	21	…	77	74	62	35	72

Sources: National central banks and bank supervisory agencies; and IMF staff calculations. Singh et. al.
Note: This table considers only deposit-taking universal banks. Data are for 2000, except for Uruguay and Mexico, for which 2002 data are used.

1Domestic banks with foreign participation or control. Offshore banks are not included.

A few large banks typically account for a large share of the system's assets. Bank restructuring that occurred during the 1990s also led to increasing concentration. Typically, more than two thirds of bank assets are concentrated in the 10 largest institutions, which hold about 70 percent of deposits and provide 75 percent of credit. The largest institutions often remain in government hands, however. This is particularly true of Brazil and Argentina, where a few public banks still account for a significant share of banking-system assets and credit. Many Latin American public banks were endowed with the role of providing credit to targeted segments of the economy, often poorer regions and sectors that had been left outside conventional channels of financing (e.g., housing, regional development, agriculture). Such operations remain important, although questions have been raised about the cost-effectiveness and governance of such activities, and alternative mechanisms—including community based microfinance—are being developed to deliver credit to such sectors.

The high degree of concentration suggests a lack of competition among banks that may be a concern. Economies of scale may be important in containing costs and taking advantage of new information technologies. A lack of competition, however, may also result in excessively high prices or quantity rationing for customers. In small, advanced economies, too, the banking system is often highly concentrated, but banks typically face strong competition from securities markets and non-bank financial intermediaries, as well as offshore markets. In Latin America, however, financing from securities markets is usually available to only a limited range of top-quality corporate borrowers.

Reforms to introduce private pension systems provided an important impetus to financial system development in Latin America during the 1990s. Chile was the first to replace a state-run, pay-as-you-go pension system with a privately managed, individually funded system in 1981. Its lead was subsequently followed in Argentina, Bolivia, Brazil, Colombia, Ecuador, Mexico, and elsewhere. These pension funds can, however, be vulnerable targets for governments looking for financing. For example, Argentina's pension funds have suffered heavy losses after being forced to invest sizable shares of their portfolios in government paper, and after the collapse of the economy in 2001-02.

b. Bank Profitability

Latin American banks' profitability improved during the 1990s, but their returns on assets and equity remain below those in industrial countries. This has occurred despite high interest margins on private lending. Interest spreads on lending to the private sector have declined somewhat during the past decade but remain high by international standards. Intermediation margins averaged more than 50 percentage points in Brazil, Peru, and Uruguay during the 1990s.[3] In part, the weak profitability performance reflects a continued reliance on interest earnings, both from lending and from government bonds.

Other sources of income, such as commissions from asset management and fees from securities trading, remain limited.

In times of high inflation, bank revenues from bonds indexed to the overnight interest rate exceeded the less frequently adjusted interest rate paid on deposits, providing banks with easy profits. Although incentives for cost reduction have increased since inflation was brought down across the region, banks' operating costs remain high, about a third higher than in banks in advanced countries, as productivity in the sector is lower, in part due to strong unionization in the sector. Nonperforming loans have been an additional burden on bank costs. Although restructuring since the mid-1990s—including by the government swapping bad loans for public securities—improved the quality of bank lending, nonperforming loans continue to represent a large share of loan portfolios.

c. Dollarization

In a number of countries, a large and rising share of both bank deposits and credits have been denominated in U.S. dollars. For example, in Bolivia, dollar deposits rose from 65 percent of total deposits in 1990 to 74 percent in 2001 and to about 95 percent in 2003. In some countries, formal dollarization was deliberately used to provide a nominal anchor for the economy. In 1991, Argentina adopted a currency board guaranteeing full convertibility between dollars and pesos, and intermediation was increasingly denominated in dollars until the collapse of the regime in 2002. Ecuador in 1999 and El Salvador in 2001 chose full dollarization to bolster price stability. Of course, conditions were different in both countries. In Ecuador, dollarization was imposed as a way to come out of a major currency crisis, while in the case of El Salvador, the actions were taken to preserve stability, that had been achieved already, while helping reduce interest rates and accelerate the process of integration with the rest of the world.

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[3] Spreads are about 13% in Latin America while the average in emerging Asia and the industrialized countries is about 3%. High spreads existed before financial liberalization, and were the consequence of non-remunerated reserve requirements, and to a lesser extent, private crowding out by the public sector. Taxes on financial intermediation, imposed as a quick way of the crisis, also contributes to the high spreads.

Some countries avoided dollarization altogether or were able to reduce it. Brazil and, to some extent, Mexico have prohibited most holdings of foreign currency deposits for non-transactions purposes, while Chile and Colombia have used strict prudential guidelines to reduce the incentives to hold foreign currency deposits. Placing a ban on foreign currency deposits or discouraging their use, however, also served to encourage the shifting of financial assets offshore. Deposits held by Argentines and Venezuelans in the United States far exceed the countries' broad money. For all of Latin America, IMF data suggests that total financial assets (excluding international reserves) held abroad amounted to some US$ 480 billion in 2005, about 23 percent of GDP, and somewhat below the level of broad money.

In recent years there has been a trend that runs against dollarization. With the EMBI spread down to about 200 bps, fixed-income investors have moved away from investing in Latin America public sector external debt into local market instruments. This trend has been positive in developing or strengthening local debt markets in Latin America and is allowing governments to reduce the currency risk of their debt portfolios. At the same time, there has also been increasing investment in corporate bonds and particularly in equity, where markets are still shallow in the region.

3. Underlying Weaknesses

The features of the Latin American financial systems today reflect a series of underlying weaknesses common to most countries in the region.

a. Low Savings rates hindered the deepening of domestic financial markets in Latin America in the 1990s. However, low bank intermediation coexisted with a wide range of saving rates; and, similarly, loan ratios and saving rates did not seem to be consistently determined by per capita GDP.
b. In most Latin American countries, an unstable macroeconomic environment has been a critical factor holding back financial system development. Chronic inflation, periodic external crises, and intermittent deposit freezes imposed heavy losses on holders of financial assets. Even after success in bringing down inflation across Latin America, inflexible exchange rate regimes and excessive fiscal deficits continued to undermine confidence and bring instability. High unremunerated reserve requirements reduced banks' available resources. Similarly, a number of countries have resorted to financial transaction taxes, which have tended to discourage financial intermediation.
c. Latin American banks have also had to cope with a range of structural factors, mostly microeconomic and institutional in nature deterred banks from engaging in lending to the private sector: Frequent crises destroyed the old client base and new customers had no credit record; inadequate auditing and accounting standards and practices hampered banks' ability to monitor both financial and non-financial companies; legislative frameworks typically did not support the enforceability of creditors' rights once loans became overdue. [4]
d. Latin American financial systems have had to cope with highly volatile capital inflows. Private inflows rose from a yearly average of US$10 billion during 1983–90 to US$62 billion by 1998, before declining to about half that amount in recent

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[4] According to calculations by Galindo and Micco (2001), if Latin American countries could increase the effective protection of creditors to the level of the developed countries, their financial markets would deepen on average 15 additional percentage points. Creditors' rights and law enforcement are lagging even in comparison with other regions with legal frameworks of the same origin (for example, some Asian countries).

years. Capital inflows were accompanied by rapid expansions of bank credit and consumption booms—and strong contractions and busts when they reversed. With limited resources from reserves and official sources, domestic policies became pro-cyclical and reduced the capacity of the government and banks to react to crises.

4. Banking Crises and Reforms

Over the past ten years, banking-system fragilities contributed to a series of financial crises. A first wave of crises hit several Latin American countries during the mid-1990s, starting in 1994 with Bolivia, Brazil, Mexico, and Venezuela, followed by Argentina and Paraguay in 1995, and Ecuador in 1996. Banks were restructured and/or recapitalized, at great fiscal cost, while regulatory systems were overhauled. In many cases the reforms were successful, but in others it was not the case. A second wave of crises hit several banking systems, including those in Ecuador in 1999, Argentina in 2001, Uruguay in 2002, and the Dominican Republic in 2003. Bolivia has experienced banking-system stress more recently, in 2003–2004.

The experience clearly demonstrates the potential for rapid contagion across borders. In the wake of the 1994 Mexico crisis, Argentine were seen as particularly exposed because of questions about the government's ability to defend the currency board Similar forces put the banking system of Uruguay in danger, after the Argentine financial system collapsed in 2002. Microeconomic influences, such as poor bank management and prudential regulation and bank supervision, were also responsible for bank problems in a number of countries.[5]

Latin American crises were typically not as expensive to resolve as those that afflicted Asia in 1997–98. The most costly crises in Latin America (in Argentina, Ecuador, Mexico, and Venezuela) cost around 20 percent of GDP to resolve, about one third to one half the costs of the costs of dealing with the crises in Indonesia, Korea, and Thailand.

To deal with these banking crises, governments across Latin America implemented a series of banking-system reforms aimed at resolving weak banks and strengthening regulation and supervision, including mergers, restructurings, privatizations, stronger prudential regulations, including on off-shore operations, and accounting regulations were strengthened, and foreign participation was liberalized.

5. Financial Integration

Financial integration in Latin America has been strongly linked to integration on other fronts. Integration through trade and FDI has been an important determinant of the integration in banking and cross listing of equity. Two features have been notable since the liberalization process of the 1990s. Large international banks have increased their presence in the region (as noted above), and firms have gained the ability to

[5]The banking crisis in Uruguay was not only the result of contagion. In addition to the fiscal and macroeconomic problems that affected the banks negatively, there was plain fraud in two large banks and
supervision was lax. Regarding contagion, problems arose because a number of banks were holding Argentine bonds to back non-resident deposits. When the supervision authorities required that they exchange such bonds for loans to creditworthy companies, the companies were unable to do so because of a freeze on banking system transactions (*corralito*) in Argentina.

increase their sources of funding by tapping international capital markets directly, mostly through the listing of Depositary Receipts (DRs) on foreign stock markets. Through these mechanisms, firms have been allowed to issue cheaper debt abroad and foreign banks have been allowed to penetrate financial markets, including the administration of pension funds and insurance companies.

Advances in formal regional financial cooperation have been very limited among the Latin American countries. Aside from NAFTA, where agreements are in place to proceed with the integration of the financial markets of Canada, Mexico and the US there has not been much progress in regional financial service liberalization beyond approval of protocols. However, some initiatives are worth noting, such as certain efforts to integrate stock markets, as well as the creation of sub-regional development banks in Central America (BCIE), the Andean area (CAF), the Southern Cone (FONPLATA) and CARICOM (CDB). In recent months MERCOSUR countries have also announce their intention to establish a new development bank, but no details are yet known about the initiative. Some CARICOM countries have moved toward a regional stock market with cross-listing and trading in securities on existing stock exchanges. The small islands of the Association of Eastern Caribbean States have a long-functioning common currency and a common central bank. Meanwhile, at a regional level, ALADI developed a reciprocal payments system to finance trade among members in 1966. The system, designed to overcome foreign exchange obstacles to trade, is currently facilitating only a small proportion of total regional trade. One of the areas in which the issue of financial integration is attracting attention is the Central American Common Market. While some efforts have been made in Central America, efforts are needed to move towards consolidated regulation with common standards across countries.

In the end, other than the increased participation of foreign banks in different countries and the trading of securities in developed countries through REITs, little progress has been achieved in regional integration. Institutional features in individual countries have precluded adequate cooperation in this regard. Policies such as eliminating controls for foreign agent participation or creating specific agreements among countries can serve as a basis for financial integration. Such agreements have been few, however. Future financial integration can also be enhanced by adopting international best practices regarding accounting standards, disclosure and sharing of information, and tax regimes. Even if full harmonization of regulations is reached, however, problems with key national institutions and macroeconomic instability can hinder the process of financial integration both with the developed world and within the region. Protection of property rights and legal stability are needed to attract regional and international players into Latin America.

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