Make or Buy? Approaches to Financial Market Integration

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1. Introduction

Latin America suffers from two financial obstacles to development. First, the region labors under a scarcity of capital, a scarcity that is reflected in the high cost and poor terms on which it is provided to most firms and households in the region. This scarcity of capital limits prospects for economic growth, and undermines real wages and living standards. Second, domestic financial systems in most countries of the region have been highly unstable. This record of instability, associated as it has been with frequent, disruptive, and highly expensive episodes of financial crisis and collapse, has been an important source or amplifier of generalized macroeconomic volatility in the region. It has also undermined confidence in the domestic financial system, thus reducing the capacity of financial systems to mobilize domestic and foreign savings, and efficiently channel them to high-return domestic investments.

What do these problems have to do with international financial integration? Consider for a moment how the world would look if reality matched the theoretical ideal of perfectly integrated world financial markets. Capital would migrate to areas where its risk-adjusted return is relatively high, which would for the most part be areas where capital is scarce, thus leading over time to a convergence of capital-labor ratios. Firms and households in different countries would have similar access to financial products, including credit contracts, savings instruments, insurance products, and payment services, after adjustment for income levels and other country-specific determinants of demand for such products.

A truly integrated global financial market would also provide opportunities for international diversification by financial institutions located in different countries, and this diversification would be particularly important for institutions located in small economies, whose share in any reasonably diversified portfolio would be quite small. This global diversification would render such institutions less exposed to country-specific shocks, although there would presumably remain important gains to a degree of geographical specialization in financial intermediation. In such a world, one might expect periodic financial crises, resulting from international macroeconomic and financial shocks, but one would not expect financial crises to be national phenomena.

It has been suggested that the financial markets of industrial countries are in fact approaching a nearly complete integration, to the point that we may speak of the Aend of geography@[1] in financial relations. But the Latin American reality is very different. The region is of course deeply enmeshed in international financial markets, and inflows and outflows of international capital have been important influence over macroeconomic outcomes in many of its countries. But while the region's interaction with international financial markets has been and remains an important factor, the integration remains shallow. And, just as shallow ports are more senstive to the tides, the shallowness of Latin America=s integration in world financial markets may make the region particularly vulnerable to fluctuations in international capital flows.

The incompleteness of the region's integration with international financial markets is easily visible from the perspective of the Latin American firms and households who are the end users of the financial resources that are allocated in those markets. In sharp contrast to a world of perfect financial integration, physical capital is for them far more scarce than in the industrial economies. This scarcity of capital has as its financial counterpart the high interest rates and restrictive terms with which most Latin American borrowers must cope.

Latin American firms enjoy, at best, very limited access to long-term debt finance for their enterprises, and equity markets provide even less financial support for domestic investment. In most countries, households face very limited access to many of the financial products that residents of industrial countries take for granted; long-term mortgages, credit for the purchase of automobiles and other durable goods, saving instruments other than bank deposits, insurance products. In this sense, too, international integration of financial markets is clearly too limited to enforce a Alaw of one price@ in the market for financial products.

[1] See, for example, O=Brien (1992).

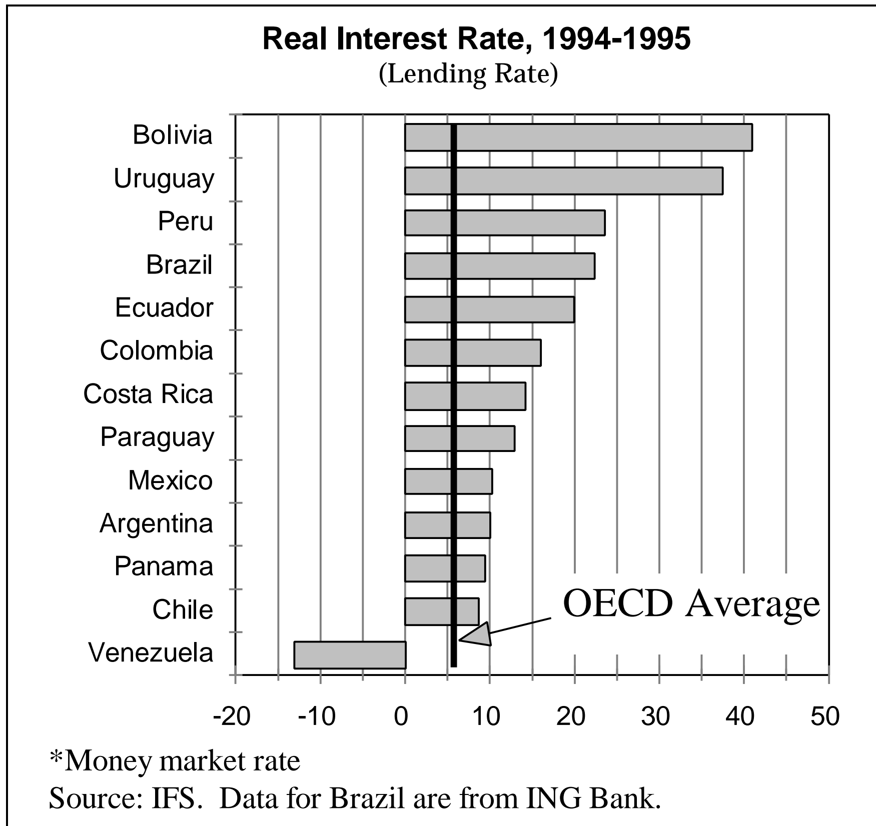


Figure 1

The sharp differences between financial markets as they exist in Latin America and how we might expect them to look under full integration suggest that the financial constraints on Latin American economic development have much to do with the incompleteness with which the region=s financial markets are integrated in the world financial system. In particular, the scarcity of capital reflects in large part the region=s limited ability to tap the world supply of savings to finance domestic investments. And the region=s history of financial volatility reflects in large part the fact that domestic financial markets have been, well, domestic, and as such have failed to secure the benefits of a broader geographical diversification, and of the financial strengths that foreign financial institutions may bring to local markets.

We will suggest that the underlying cause of Latin America=s limited integration with world financial markets is not explicit barriers to international financial transactions, but rather weaknesses in the domestic financial markets that would be called upon to intermediate international capital flows. These weaknesses, in turn, reflect two types of problem: first, that financial services are very intensive in certain public goods that Latin American governments have found it difficult to provide, including contract enforcement, adequate regulation and supervision, lender of last resort facilities, and deposit insurance. Second, financial markets have had to face much more economic volatility, making compliance with contracts more difficult and commitments more difficult to honor, thus undermining the credibility of the domestic financial system. While these problems are in principle largely domestic in origin, they may be more effectively solved through strategies that involve the rest of the world. An appropriate financial integration approach can strengthen and deepen the domestic financial system by permitting the indirect importation of the requisite public goods (provided by the banks= home countries) and by allowing a greater diversification of national risks. Hence, appropriate integration could more quickly create the domestic conditions for a more stable and sustainable financial development, which would have the additional benefit of increased access to the world pool of capital.

We begin the discussion with a brief review of Latin America's integration in the international financial system. We then discuss what we mean by "deep" financial integration, what such integration would require, and the special obstacles to such integration in Latin America. We then provide an overview of the ways in which a deeper financial integration could benefit the region, and conclude with an approach to achieving such an integration.

2. How integrated is Latin America in world financial markets?

It may at first glance seem peculiar to take seriously the idea that Latin America enjoys insufficient access to world financial markets. Many of the world's most indebted economies are Latin American. Didn't the region just suffer 10 painful years of recovery from a major debt crisis? Didn't we just face the task of restructuring external debts in a number of Latin American economies? Periodically occuring Latin American debt crises seem to provide ample evidence that the region has, if anything, enjoyed too much international financial rope, without which its occasional macroeconomic hangings might have been less frequent. And moreover, the key policy challenge of the 1990s has in most countries been provided by excessive, rather than insufficient inflows of international capital.[2]

But excessive by what standard? Latin America's traumatic history has taught many of its observers that a country's capacity or willingness to continue paying its creditors comes into question when the country's foreign liabilities approach something like 50 percent of GDP, and when countries are required to transfer to their foreign creditors amounts of around 6 percent of GDP. In 1982, the year in which the debt crisis broke out, net factor payments reached about 8-1/2 percent in Argentina and Chile, just over 7 percent in Mexico, 5 percent in Brazil, 4 percent in Peru, and 2 percent in Venezuela. In 1993, just before the 1994 ATequila@ crisis, net factor payments by Mexico amounted to less than 4-1/2 percent of GDP.

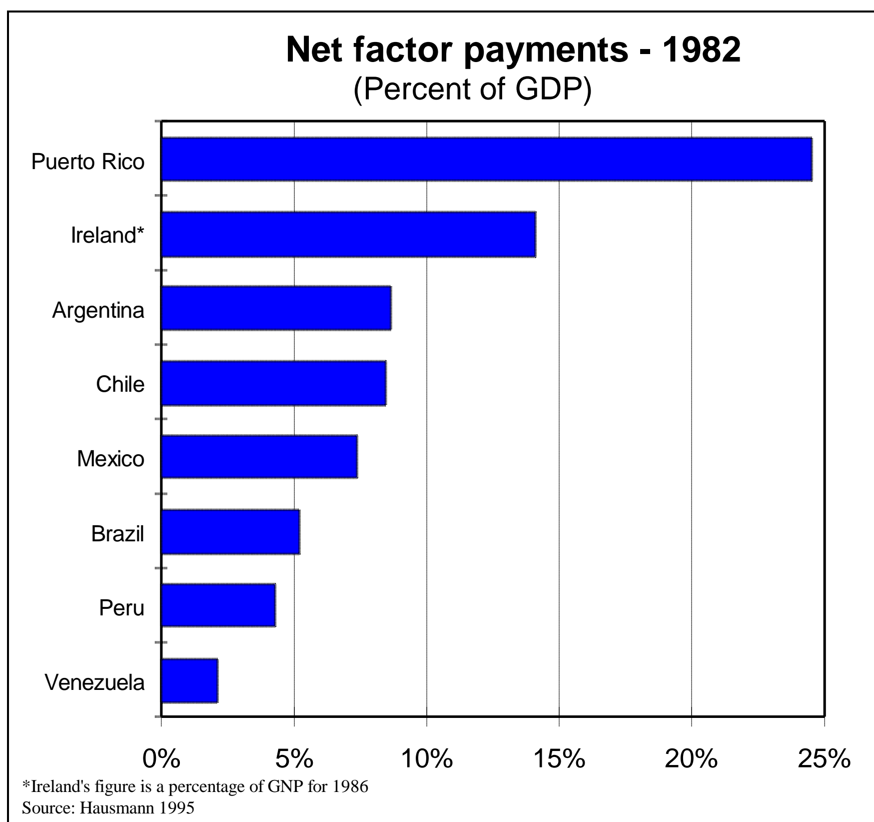
The interesting question is why Latin American creditworthiness comes under question at such low levels of foreign liability. These international liabilities, and the transfers to foreign creditors that they require, are low by historical and some more recent standards. The most dramatic example is Puerto Rico today, where decades of capital flows have led to a very large stock of foreign investment in the island, requiring net factor payments to foreign creditors

[2] See, for example, Calvo, Leiderman and Reinhar (1996). Gavin, Hausmann and Lederman (1995) review the Latin American context.

of nearly 25 percent of GDP in 1982, rising to roughly a third of GDP in 1994 and 1995.[3] In effect, international capital markets have during the past several decades moved huge amounts of capital into Puerto Rico, in the process providing the country with an income and level of exports higher than any other country in Latin America, despite having one of the lowest rates of saving. Foreign savers have, without any fuss, been paid the returns to this capital, while Puerto Rican workers have benefited from the higher labor productivity and wages that the larger capital stock has made possible.

Figure 2

[3] See Hausmann (1995), from which the data on Puerto Rico are extracted.



A similar, though somewhat less dramatic example is provided by Ireland, which was the recipient of enormous capital inflows during the late 1970s and early 1980s. These helped finance an impressive investment boom, which peaked in the late 1980s at over 30 percent of GDP, while Irish GDP per capita rose from 52 percent of the OECD average in 1970 to 68 percent in 1993. As a result of the large foreign investments, net factor payments peaked at nearly 15 percent of GDP in 1986, two to three times the levels associated with the debt crisis in Latin America.

Somewhat more remote, but nevertheless revealing examples are provided by the international lending boom of the last century. During the last forty years of the 19th century, net foreign investment in Australia averaged about 5 percent of GDP, and during the ten-year period 1880-1889 it averaged 9 percent of GDP without creating a crisis.

Canada borrowed at similar rates in the first decades of the 20th century.[4] In both countries this foreign investment financed major investment booms that were important contributors to the countries' industrialization.

These examples indicate that there is no economic law which limits foreign investment to the relatively low levels that have proven sustainable in Latin America, and that the limited access to international capital may be due to institutional and policy shortcomings that can be remedied. If so, the implication is that the region has the ability to jump-start its development by tapping the vast pool of international saving. This highlights the fact that greater financial market integration should not be thought of as a long-run objective, to be achieved after industrialization has occurred, but rather as an instrument for accelerating it. Australia, Canada, Puerto Rico and Ireland were developing countries that were able to use their links with international financial markets as a means of accelerating the process of industrialization.

As we have noted, international capital flows have fallen far short of the levels that would be required to equalize capital-labor ratios and bring rates of return to capital in Latin America down to industrial-country rates. As Figure 3 illustrates, Latin American workers must, on average, make do with about a third the capital available to industrial-country workers, and in many countries of the region the scarcity of capital is much more extreme.[5]

This scarcity of physical capital has as its financial counterpart the high cost and poor terms on which capital is made available to the vast majority of Latin American firms and households that do not enjoy direct access to

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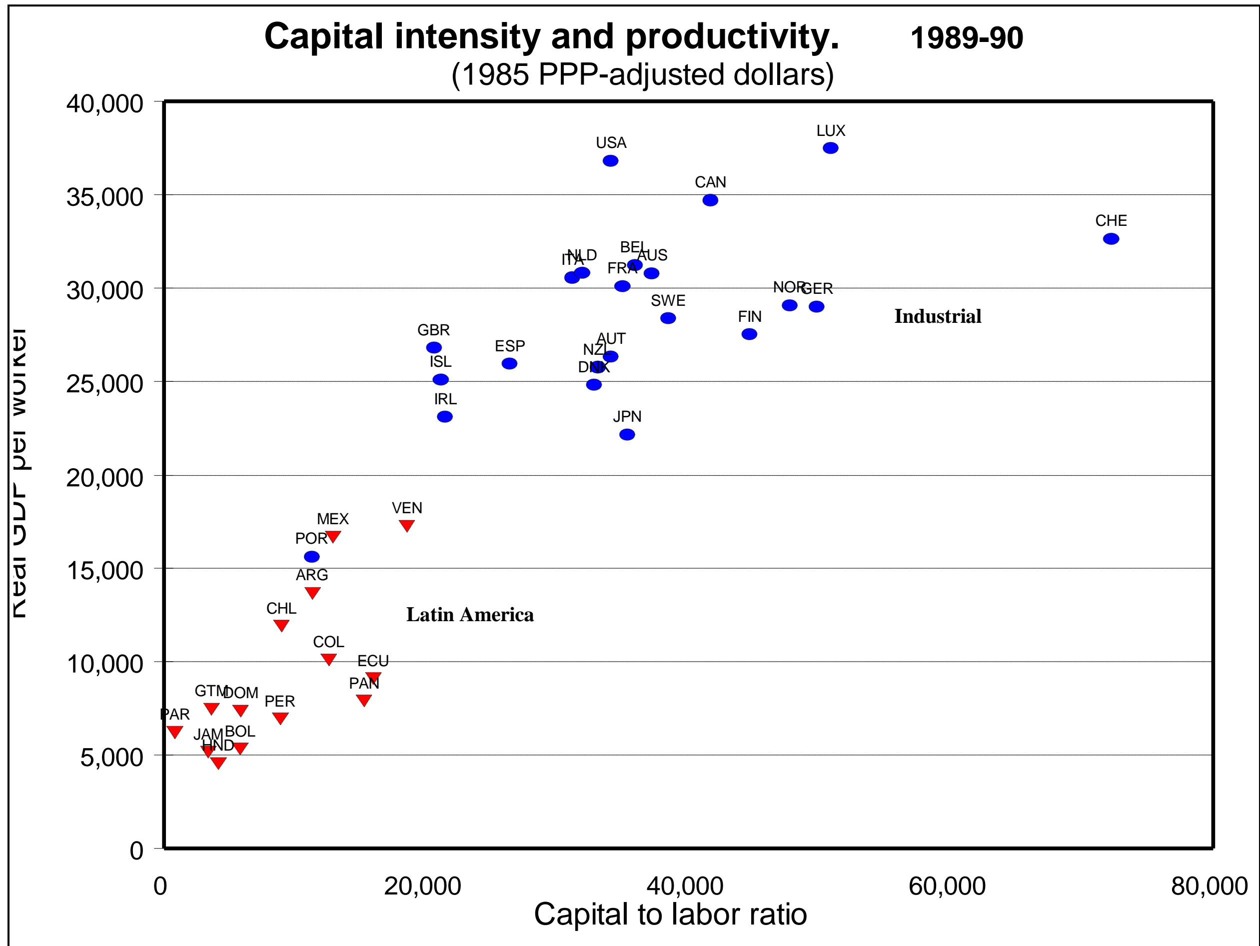
[4] Edelstein (1982). International lending to Argentina, India, and South Aftrica was also very large in the late 19th and early 20th centuries. In Argentina the lending boom ended in tears with the 1890 panic and international debt crisis.

[5] The data are from the Heston and Summers database, and refer to the nonresidential capital stock. Some of the data are a little puzzling, such as the very low capital-labor ratio recorded for Paraguay. But the message delivered by the data is not at all sensitive to such outliers, and a similar message emerges from calculations based upon World Bank estimates of the capital stock.

international financial markets. As can be seen in Figure 1 (above), during the past two years, real lending interest rates have been near or well above 10 percent in almost every large Latin American economy, and have exceeded 20 percent in Brazil, Ecuador, Peru, Uruguay and Bolivia. These rates of interest do not, of course, provide a



precise measure of the rate of return to physical capital in these economies, but they do convey a sense of the scarcity of capital in the region.

Figure 3

It is true that high domestic interest rates often attract international capital, but these inflows are volatile and frequently take the form of highly liquid financial instruments such as bank CDs and short-term government paper. Such inflows do reflect a degree of integration with international financial markets, but it is a very shallow integration, for these volatile and easily-reversed inflows cannot prudently be intermediated to finance longer-term investment projects.

Not only is capital scarce and expensive in Latin America, but many financial products that would be taken for granted in most industrial economies barely exist in Latin America. Even relatively wealthy Latin Americans face much more limited access to long-term mortgage finance than is provided to households of similar income in industrial economies, and when it is available, lenders are typically willing to finance a much smaller fraction of the purchase price. The range of available savings instruments is also much narrower than can be found in most industrial economies, and insurance contracts are less widely available. There are few, if any, explicit barriers to the provision of these financial products but it does not happen. In this sense, too, Latin American financial markets and the products offered on them are predominantly local, not international.

This state of affairs is not the inevitable result of Latin America=s relatively low level of economic development, as can be seen from the very interesting example provided by Panama. In that country, the domestic financial system mobilizes financial resources at a rate that is impressive by industrial country standards, and enormous by the standards of Latin America.[6]

In Panama, bank lending to the private sector exceeds 80 percent of GDP, nearly twice the ratio mobilized by the nearest Latin American country, and well over twice the ratio observed in Argentina, Colombia, Mexico, Brazil, Venezuela, or Peru. And this is not merely a reflection of a relatively high level of development; its per-capita GDP is lower than every one of these countries except Peru.

[6] Panama also has a large offshore banking sector. That sector is, however, segregated from the domestic finacial system, and its operations are not included in the figures discussed here.

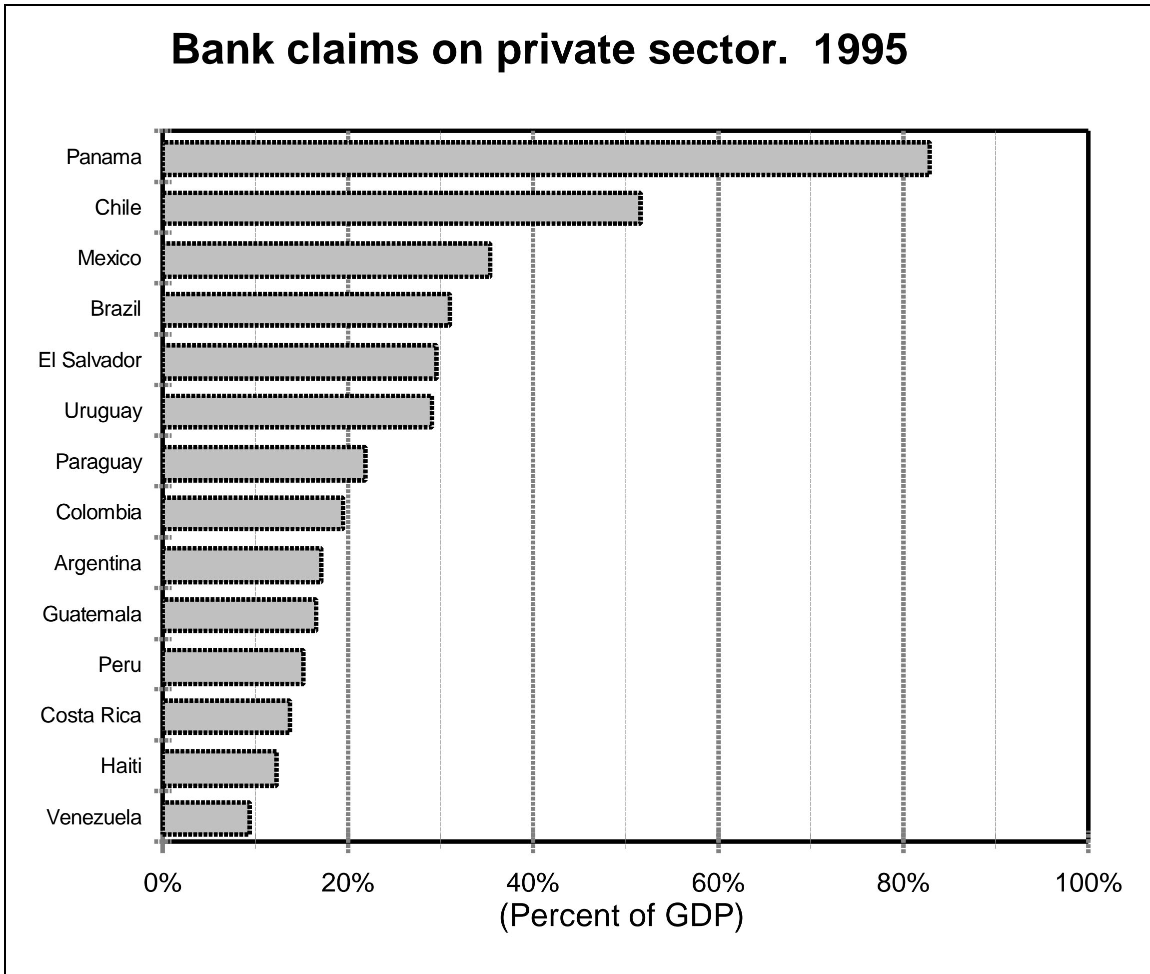


Figure 4

Accompanying Panama=s high level of financial intermediation is a much richer array of credit instruments for firms and households. Banks finance consumer purchases, and make long-term mortgage loans. In fact, at 25 percent of total bank lending, mortgage lending in Panama is roughly as large a share of GDP as is total credit to the private sector in

much of Latin America.

Table 1 External Debt and Indicators of Creditworthiness		
	Stripped spread on Par Brady Bond, Aug. 1996 (percent)	International debt (percent of GDP)
Argentina	9.54	49.7
Mexico	6.75	44.9
Panama	4.70	124.7

Source: Stripped spread, ING Barings. International debt, World Bank *World Debt Tables.*

Panama also appears to have significantly greater access to international financial markets than do most Latin American economies. That access is not unlimited - Panama did need to restructure its international debt along with much of the region - but indicators of the risk attached to Panamanian debts are substantially lower than in, for example, Mexico and Argentina, despite the fact that Panama=s international debt is substantially higher than that of either country. Despite having an international debt that is, as a share of GDP, 2-1/2 times as large as in Argentina and Mexico, the stripped yield on Panamanian Brady bonds has recently been about 470 basis points above US Treasuries, substantially below the spreads recorded in Argentina and Mexico.

The depth of Panamanian financial markets may be due to several factors. We describe it here mainly to serve as a benchmark for the kind of financial development it is possible to achieve with the right policy and institutional framework, even in countries at relatively low levels of economic development.

In short, the enormous and persistent gap between the capital intensities of Latin America and the industrial economies, and the associated differences in the cost of capital, have not generated the large and sustained capital flows that one would expect to see in a fully integrated world financial market. The inflows that do take place often take easily-reversible forms that cannot prudently be intermediated to finance the long-term needs of the the region=s private borrower. Many financial products that are readily available to firms and individuals in developing economies barely

exist in Latin America, even where income levels are high enough to generate a demand for them. All of these facts reflect a very limited integration with international financial markets. Modern and historical examples suggest that a deeper integration is possible, and the limited nature of Latin America=s access to international capital thus requires an explanation. We now discuss some of the reasons.

3. What do we mean by financial integration?

But first we had better clarify what we mean by financial integration. Discussions of international financial integration usually conceive of such integration in one of two ways. On the one hand, integration often refers to a reduction of policy barriers to international capital mobility, and on the other it may refer to the reduction of barriers to international trade in financial services. In discussions of the first kind, the supporting analytical framework is a macroeconomic model of some sort or another, and the policy issues have mainly to do with the danger of unintended adverse consequences of potentially volatile international financial flows in a world plagued by various macroeconomic frictions. In these, largely macroeconomic, discussions the process of financial intermediation, and the treatment of the financial sector as an industry, is for the most part neglected.

By contrast, in discussions of trade in financial services these macroeconomic issues are largely set aside, the focus is placed on the financial system as an industry, and the emphasis is given to issues such as ensuring "fair" market access, and that international trade in financial services does not undermine key objectives of the prudential regulatory and supervisory regime. Even the loci for international discussion of the two issues differ, with the OECD and the IMF providing the major fora for discussions of international capital mobility, while the World Trade Organization covers issues surrounding trade in financial services.

For our purposes both capital mobility and trade in financial services are central, and in fact we wish to emphasize the interaction between the two. This interaction results from the fact that transfering capital across borders and making it available to appropriate final users is costly; it requires the output of the financial industry. Thus, while increased capital mobility, in the sense of securing an enhanced ability to access the world supply of savings, is a key objective of financial integration, we argue that further liberalization of explicit barriers to capital mobility - where they

still exist - is unlikely to achieve this end. This is because the binding constraint on the region's access to international financial markets has little to do with such explicit barriers, and much to do with more fundamental problems in the local intermediation of domestic and foreign financial resources. We suggest that promoting "deep" financial integration is an important element of a strategy to overcome these problems, though for reasons rather different than those emphasized in most discussions of trade in financial services.

By "deep" financial integration we mean a financial market in which domestic residents - households, major corporations and small businesses alike - would have access to financial products on terms similar to those offered to similarly-situated users of such products in the developed financial markets such as the United States, Europe, and Japan. In a capital-scarce region like Latin America, this would require channels through which the world's savings could flow to the local financial markets. Crucially, it also requires the effective intermediation of these external, as well as locally-generated, financial resources. Since the channels already exist for saving to flow out, this goal is all the more important.

4. What is required for deep financial integration?

One can imagine a number of market structures and institutional frameworks in which this intermediation could take place, but in all of them the intermediation must involve the resolution of important information and incentive problems that afflict debtor-creditor relations. These problems arise because financial intermediation is the process of exchanging contractual claims on risky, future income streams. Not only is the borrower's future capacity and willingness to repay uncertain at the time these contracts are made, but the borrower typically has an informational advantage over the creditor, and may also be in a position to take actions that undermine the financial interests of the creditor, to his own benefit. Lenders must, therefore, learn about their borrowers, find ways of limiting the problems of adverse selection and moral hazard that arise as a result of the informational asymmetries, and assure that borrowers have the right incentives to repay.

Production of the requisite information and resolution of the incentive problems is the main business of the domestic financial sector (which may, of course, include participating institutions from any part of the world).

International capital mobility requires the presence of a well-functioning domestic financial system. To the extent that the financial sector performs well, the funds channeled through it are likely to be productively employed, and because of this, the financial system is likely to enjoy greater access to international financial resources. If the sector performs poorly, the resources that it mobilizes will be inefficiently employed and, as a result, the domestic financial system will find itself with limited access to international financial resources.

While coping with the information and incentive problems that stand between it and its debtors, banks[7] create a second layer of information and incentive problem in the relation between the bank and its creditors, specifically depositors, who are for the most part in no position to evaluate the quality of the bank's portfolio. This information problem is aggravated by implicit or explicit deposit insurance, which largely eliminates incentives for depositors to monitor and impose market discipline on banks. This then leaves the way open for banks to engage in excessively risky behavior, and they face strong incentives to do so because their owners keep the income earned by good outcomes, while taxpayers pay much of the cost of bad outcomes. Banks are also vulnerable because of their inherent illiquidity: one of their purposes is to use short-term deposit liabilities to fund longer-term investments. This creates the risk of a self-fulfilling crisis in which an abrupt withdrawal of deposits forces a bank to liquidate its assets at fire-sale prices, thus driving a potentially sound bank into insolvency. The costs of bank failure and the potential for contagion, either by generating panic about other banks or through disruption of the payments mechanism, motivates many governments to create lender of last resort functions which, like deposit insurance, create moral hazard problems of its own.

Almost everywhere, the highly imperfect resolution of this problem has been for governments to provide some form of deposit insurance and create a lender of last resort facility, while attempting to limit the consequences of the moral hazard problem that it creates for banks by regulating their activities, and seeking to ensure that last-resort lending

[7] We focus on banks in this paper because of their importance in Latin American financial markets, and because it is with banks that the most acute policy issues arise. We note that intermediated debt contracts administered by banks are dominant in Latin America precisely because of the information problems that make banking, and public policy toward banking, such a complex business.

is confined to solvent but temporarily illiquid banks.

This means that successful financial intermediation is highly intensive in publicly provided services. National (or subnational, as in the United States, where state as well as national governments charter and regulate banks) governments are faced with the need to charter banks, with the aim of excluding unfit institutions from the market, and to develop the regulatory and supervisory structure required to address the moral hazard problems created by the various forms of (imperfectly priced) insurance provided by the government. The lender of last resort requires substantial financial Amuscle@, the ability to make resources available to the financial system without creating the destabilizing expectation that the transfer will in the end be monetized, and create a burst of inflation.[8] This cannot be taken for granted in Latin America, where there is little Afiscal slack@, and as a result adverse fiscal shocks have often generated inflation. The lender of last resort requires some capacity to evaluate the soundness of the banks under his charge, so that he can at least attempt to distinguish fundamentally sound but illiquid institutions from those that are insolvent. Setting prudential norms and supervising their compliance are complex tasks, involving the accumulation and evaluation of information on complicated transactions from institutions that may have an incentive to obfuscate their financial position, and they require a stable and skilled cadre of experts in the public sector.[9]

At an even more basic level, the financial system is highly dependent upon effective adjudication and

[8] Gavin, Hausmann, Perotti and Talvi (1996) show that fiscal shocks in Latin America are often associated with a bust of inflation, unlike in the United States.

[9] The difficulties are highlighted in Hovakimian and Kane (1996) who provide evidence that, even in the United States, with its massive supervisory apparatus, regulators have been unsuccessful in preventing banks from shifting risk to taxpayers. As we will argue below, there is good reason to believe that Latin American regulators are likely to have even more difficulty than their industrial country counterparts. While there may be ways in which regulators could harness market forces more adequately than current regulatory structures do, thus economizing on the demans created for the public-sector, effective supervision of financial markets is likely to remain a complex governmental problem.

enforcement of private contracts, the public good *par excellence.* This requires that the government provide some mundane, but in some countries neglected, services such as credible registration of property ownership, and it requires a competent and independent judiciary with the resources required to achieve a rapid and fair resolution of contract disputes.

These considerations are so fundamental that they have driven the creation of financial markets which are essentially Anational@, not international, whose existence we now take largely for granted despite the absence of any economic rationale for national delimitations on the activities of financial institutions. Bank charters are national, and the associated "domestic" financial system largely so, not because national borders provide a sensible geographic definition of a financial market, but because the activities of chartering, regulating, insuring, and providing for the adjudication and enforcement of property rights require acts of government, including use of its enforcement powers, that can take place at the national (or subnational) level, but not at the international level.

The United States banking system, with its history of state-chartered and regulated institutions and strong restrictions on interstate banking activity, illustrates this point well. It makes little economic or business sense to define New Hampsire, Wyoming, Louisiana or the other states of the Union as "financial markets" separate from one another, yet even now banks throughout the country face significant restrictions on their ability to do business outside their own state. This state of affairs is due to the historical accident that in the early part of the country's banking history it was states, not the federal government, that took responsibility for providing the legal and regulatory infrastructure for banking activity in the United States. It is sometimes difficult for outsiders to the United States to understand the logic of these economically arbitrary restrictions on the banking business, for in economic and business terms there is none.

But the economic and business rationale for defining Argentina, Bolivia or Mexico as financial markets separate from the world financial system is little stronger than it is for Texas. The existence of a "domestic" financial market in these and other countries in the region is the result of political, not economic or business considerations, and we argue below that there would be important economic gains from relaxing the political constraints and attempting to merge domestic markets more completely with international financial markets.

Operating within the framework provided by domestic financial systems in the region and outside it, there is

of course substantial international financial activity. This activity creates an additional level of complexity and introduces new complications for the public sector. One of these complications is sovereign risk; when foreign institutions lend to governments, they do so with the realization that there are no means of forcing borrowing governments to comply with the terms of financial contracts; repayments will only occur if it is in the interest of the borrowing government. This places important restrictions on borrowing by sovereigns, which will be more severe the smaller the capacity of governments to commit themselves to future actions.

Cross-border lending to the private sector involves additional complications. To the extent that foreign participants lend in domestic currency, they face exchange-rate risk that they may not wish to bear. This is a particularly heavy burden for economically volatile regions such as Latin America. Arguably a more important consideration is that the existence of a national currency, and the currency exchange arrangements that accompany it, provide a mechanism through which governments can more easily interrupt payments to foreign individuals and institutions. Panama is an interesting outlier in this respect. With no national currency or central bank, the country's ability to intervene in international payments is substantially more limited than in countries where exchange-controls can be imposed. This missing degree of freedom may be one reason for the Panama's relatively high perceived creditworthiness, discussed above.

Finally, foreign participants in domestic financial systems may be concerned that the legal system will operate to their disadvantage. Foreigners are likely to be at a special disadvantage when systems operate in a less than fully transparent manner, simply because rights are protected by a political system in which they are not represented. And if the legal system lacks autonomy and is subject to the influence of important social or business groups, foreign residents may have particularly good reason to fear that their interests will be neglected by local courts. For some transactions, an agreement that disputes will be adjudicated in the courts of the lender's country can alleviate some of these concerns, assuming of course that the lender comes from a country with a reasonably reliable legal system. But this will not always be possible and, even when it is possible, problems remain because the lender's legal system will typically be powerless to enforce its decision, and the borrower's government may be uninterested in doing so.

Let us summarize the key points of this discussion. We have argued that deep financial integration requires

the output of a financial system that must effectively intermediate the resources provided by the rest of the world, transforming the world's saving into financial products for use by domestic households and firms. This intermediation requires competent financial institutions, whether domiciled at home or abroad, operating in the local financial market. But these institutions cannot operate effectively in the absence of important public goods that governments must provide the industry. A legal system must be maintained to adjudicate and enforce contracts promptly and fairly. A regulatory and supervisory structure must be erected and maintained. A lender of last resort must be created with the financial capacity to support solvent, but illiquid institutions without resorting to inflationary finance, and the technical capacity to reduce the likelihood that insolvent institutions will be bailed out. Without these crucial public inputs, international financial intermediation is likely to be both limited in magnitude and uncertain in effect.

This is true in all countries. But not all countries are equally capable of providing these public inputs, and as we shall now argue, there is reason to believe that Latin America has a comparative disadvantage in their production.

5. Special obstacles to financial integration in Latin America

The role of the public inputs that we have emphasized - macroeconomic stability, an appropriate regulatory and supervisory framework for the industry, and effective adjudication and enforcement of financial contracts - is often neglected, perhaps because in the industrial economies their existence can be taken for granted. This is not the case in Latin America.

Latin America has, first, been plagued by enormous macroeconomic and financial volatility; in terms of most nonmonetary outcomes it is more volatile than any region of the world other than Africa and the Middle East, and in monetary instability it is in a class of its own. This volatility undermines the financial institutions that are exposed to national economic fluctuations. The vulnerability of domestic financial institutions to national economic shocks creates an amplification of the original disturbance. As individuals realize that a country-specific shock may threaten the viability of the local banking system, they attempt to escape it by withdrawing their deposits. If the central bank does not respond, this liquidity shock forces banks to contract their lending to the nonfinancial private sector, thus deepening the adverse economic shock. This is the situation faced by Argentina in 1995. More typically, central banks will feel

obliged to provide liquidity to the domestic banking system, increasing and in the end validating the public=s fears of higher inflation and macroeconomic instability.

To prevent this destabilizing link between adverse macroeconomic shocks and the demand for domestic bank deposits, and to control the problems of moral hazard discussed above, financial institutions whose activities are highly concentrated in one Latin American economy need to be substantially more highly capitalized and more liquid than would be appropriate for institutions located in a more stable environment. This limits the financial system's capacity to mobilize financial resources and channel them to productive uses.[10]

A second obstacle to financial integration is the public sector. Latin America has traditionally possessed weak public sectors, with limited technical and administrative capacities, and lacking the autonomy from special interest groups required to execute policies that benefit the general public.[11] And, while the reforms of the past decade should eventually result in a more focused and strengthened state, the Latin American state has in the short run been weakened by a decade of debt crisis and the fiscal retrenchment that followed it.

The incapacities of the Latin American state are particularly exaggerated in exactly the areas in which effective state action is most required for building a sound financial system. As we have emphasized, the public "infrastructure" required for a sound financial system demands a stable and highly competent cadre of public servants. But wage levels of the senior officials in Latin America are extremely low, both by international standards and in comparison with those provided by the local private sector. Reflecting these low wages and a high degree of political instability, turnover is very high. This lack of continuity seriously undermines the local technical capacity for supervision and regulation of the

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[10]See Gavin and Hausmann (1996) for a lengthier discussion of this point. Rojas-Suárez and Weisbrod (1996) also emphasize the importance of enforcing capital requirements.

[11]See Naím (1995) for an extensive discussion of the state in Latin America, from which much of the following discussionis drawn.

domestic banking system, and the credibility that the services will be adequately provided in the future. At the same time, in many countries the state's lack of autonomy from specific interest groups raises a heightened danger that decisions will be unduly subject to pressures from influential groups. Moreover, most governments lack the financial resources required to carry out deposit insurance and lender-of-last-resort functions.

In short, Latin America possesses a comparative disadvantage in providing the public goods required for an effective financial system. The unstable macroeconomic environment threatens financial institutions whose business is largely confined within national borders. And deficiencies in the legal, regulatory and supervisory infrastructure limit the development of local financial intermediation by domestic and foreign financial institutions alike. What is the appropriate policy response?

We can think of two approaches to the problem. The first would take the limited internationalization of Latin American financial markets as given, and work within that structure to build a more stable and efficient system. The main elements of such a strategy would include:

1. Work toward the establishment of a more stable macroeconomic environment;
2. Reform the civil service, including in particular the bank regulatory bodies and the judiciary with the aim of creating a public sector with the ability credibly to regulate and supervise the financial sector, and to adjudicate and enforce financial contracts;
3. Ensure that domestic banks are highly capitalized and liquid, so that they can withstand the substantial macroeconomic and financial shocks that are likely to impinge upon the predominantly local institutions.

These are laudable objectives. It is impossible to argue with the desirability of promoting a more stable macroeconomic environment, or strengthening the public sector. The reform of the civil service and the judiciary is a necessary but very long-term investment. Latin America can ill afford to live with the present state of financial affairs while we await the results of these endeavors. And, while ensuring that the domestic banking system is highly capitalized and liquid may be preferable to the vulnerable and crisis-prone system of the past, it carries with it an important cost in the form of a reduced capacity for and increased cost of financial intermediation.

In the section that follows we argue that some of these costs can be avoided if a somewhat different strategy

is pursued. In this alternative strategy, the ingredients of a stable and efficient financial sector would not only be "made" domestically, but would be "bought" in an international market, thus alleviating the shortcomings of the state by easing the burden on the state now, rather than waiting for the time-consuming procees of building state capacity to bear fruit. This strategy would allow the importation of the expertise and financial strength of international financial institutions, but also and arguably more important, would permit the indirect importation through those banks of key public inputs for a sound and efficient financial system.

6. What can international financial integration achieve?

Let us recapitulate the argument as it stands so far. We have argued that Latin America faces two key financial problems: a scarcity of capital and a volatile, crisis-prone financial system. Both of these problems are, in large part, a reflection of the region's limited integration with world financial markets. The shallowness of the region's financial integration is, in turn, largely attributable to weaknesses in the domestic macroeconomic and financial environment, which limit the effectiveness with which financial resources can be intermediated by domestic and foreign financial institutions alike, and therefore limit the capacity for the region to tap the world supply of capital. Weaknesses in the domestic financial system are grounded in two causes: an inadequate provision of the public goods required for a strong financial system, which reflect the fact that the public sector in Latin America often lacks the institutional and financial capacity to produce the complex services involved in managing a regulatory and supervisory structure; and the volatile macroeconomic and financial environment in which banks have had to operate.

There is good reason to believe that a financial integration strategy that involves the opening of domestic financial markets to foreign banks and the geographical diversification of domestic banks, can promote financial stability. This is for two reasons. First, international banks have access to their parents' stock of capital and international liquidity if they find themselves in trouble. Here there is an important distinction between branches and subsidiaries of foreign banks. If the foreign bank is a branch of a bank domiciled abroad, it shares the parent=s capital, and the parent has a legal obligation to support the branch if it comes under pressure. If the the local institution is a subsidiary of the parent, it is a separately capitalized legal entity. The parent company will have an interest in supporting the subsidiary, to protect

its reputation, but not the legal obligation. The bank may use the threat provided by its option to let the local subsidiary go bankrupt to extract concessions from the host government in the event of a major crisis. This is not merely a theoretical danger; in the recent Argentine crisis some subidiaries of international banks were denied support by their parent institutions. This is one important consideration that weighs in favor of encouraging the establishment of local branches, rather than subsidiaries, of international banks, as we discuss below.

Second, internationally diversified banks are likely to be more robust in the face of country-specific shocks simply because a substantial portion of their assets will be invested in regions unaffected by that shock. This is particularly important for Latin America, because the highly volatile macroeconomic environment in which banks must operate raises the benefits of risk diversification. The increased resilience of banks will reduce the frequency of financial crises, and increase confidence in the domestic financial system. In particular, depositors will have less reason to fear that a macroeconomic shock will bring down the banking system, and will therefore be less likely to engage in a destabilizing flight from domestic deposits when an adverse shock arrives.

The benefits for Latin America of international diversification are essentially identical to the benefits to the United States of relaxing restrictions on interstate banking, which long inhibited the emergence of banks operating in many parts of the country. Because of these restrictions, it is possible to identify state-specific banking crises due, for example, to the collapse of oil prices on banks in Texas. Texas banks were vulnerable to this shock mainly because restrictions on interstate banking made the Texas banking system highly exposed to this state-specific shock, just as restrictions on international activities make Latin American banks vulnerable to national shocks. The situation for Latin American banks is, however, even more precarious than for Texas banks, because the impact of local shocks on Texan banks is buffered by the fact that they enjoy federally-backed deposit insurance and a federally-organized lender-of-last-resort facility, which together reduce the likelihood that such a shock will be amplified by a flight of depositors from the Texan banking system. Latin American banks do not enjoy analogous support.

The benefits of diversification can also be seen from comparisons of financial developments during the Great Depression in the United States, where banks were small and confined to small geographic area, and in Canada, where banks were permitted to establish branches throughout the country. In the United States, about a fifth of the banking

system failed, and a third of the nation=s banks disappeared as a result of failure or merger. In Canada there were no panics or runs, though there was a 10 percent drop in the number of branches. Haubrich (1990) argues that these branch closures were macroeconomically less disruptive than the failures that occurred in the United States.[12]

Even if banks diversify only within Latin America, there are significant gains to be had. In Figure 5 we compare the standard deviation of GDP growth of countries in the region to the standard deviation of a regional Aportfolio@, weighted somewhat arbitrarily by the country=s real GDP.

For every country except Colombia, the regional basket shows substantially less volatility than has the individual country. For particularly volatile economies like Ecuador, Peru, and Chile the diversified basket has roughly half the volatility faced by the individual country. Even greater gains from diversification are found for the terms of trade, where the basket has substantially lower volatility than any individual country, and for countries like Venezuela and Ecuador the volatility of the basket is only a quarter the volatility of the country=s own terms of trade. Real GDP growth and the terms of trade are only a few of the determinants of business risk for banks, but these figures nevertheless suggest that diversification within Latin America could provide banks with real opportunities to reduce risk.

To the extent that international diversification makes banks more resilient to national shocks, it will have an important stabilizing influence on the macroeconomy more generally. At present, the financial system often amplifies national shocks. This is because, fearing that a major shock threatens the solvency of the insufficiently-diversified domestic banking system, depositors often flee, seriously aggravating the underlying problem. By weakening the link between national shocks and the solvency of individual banks, this amplification could be reduced or eliminated, leading to a more stable financial system and macroeconomy. This, in turn, is likely to improve the quality of domestic financial intermediation and relax a key constraint on attaining a deeper financial integration.

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[12]See Haubrich (1990). Calomiris (1990) provides evidence that geographical diversification *within* US states may have been important, noting that in the 1920s states that did not permit branching experienced much higher bank failure rates than did states where within-state branches were permitted, reflecting in part the greater diversification of multi-branch banks.

The presence of international bank branches can also strengthen the domestic financial system by easing the burden of regulation and supervision placed on the Latin American state, because branches are supervised by the home country authorities. Assuming that the branches are of banks with adequate supervisors, this relieves domestic authorities of responsibility for detailed oversight of the branches activities. Since parent institutions have legal responsibility to support their branches, and deposit insurance and lender-of-last-resort facilities would be provided to the parent, if required, by the homeauthorities, the financial burden facing the Latin American host is greatly reduced as well.

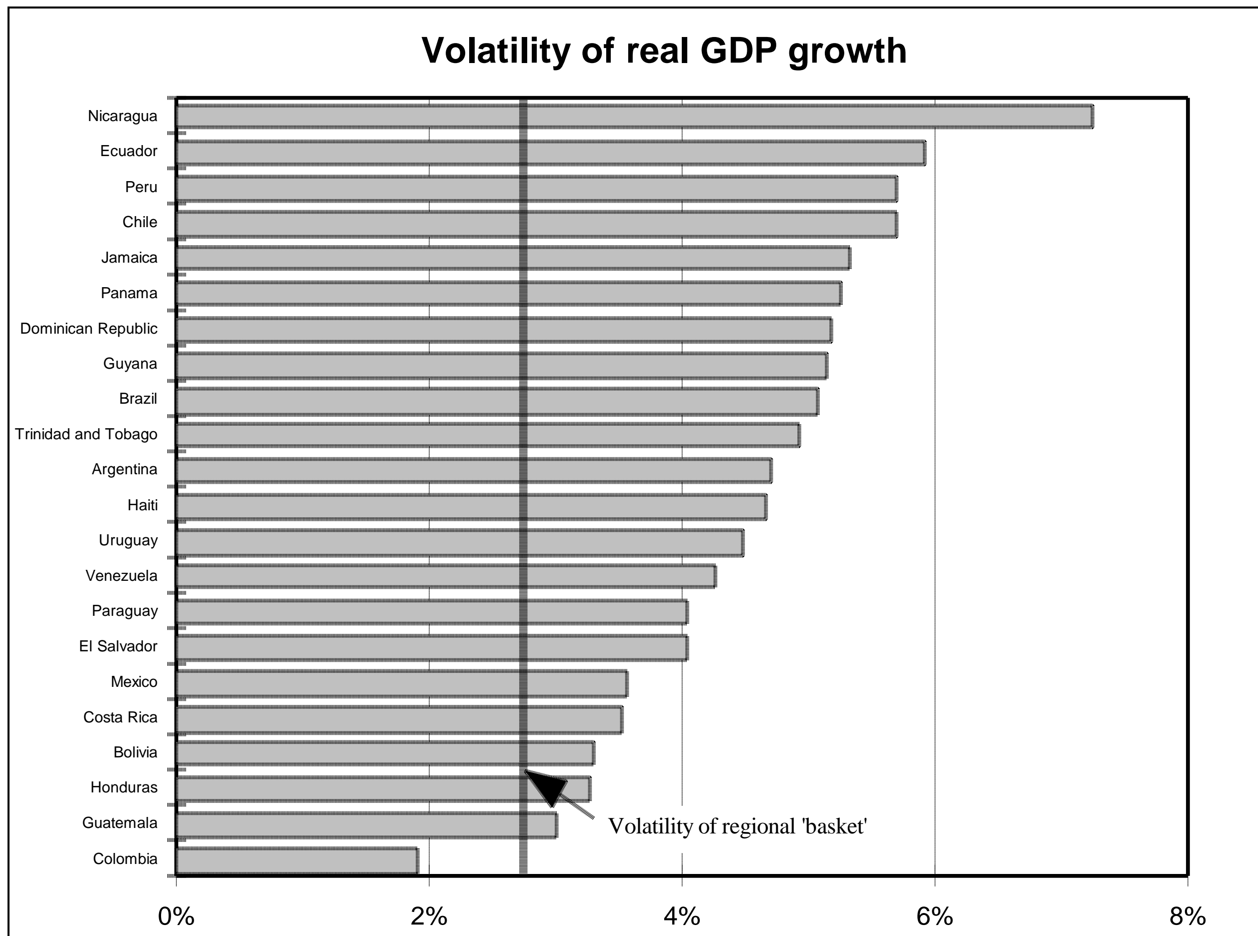

Figure 5

Arrangements would be required so that domestic depositors in the foreign branch would be insured against failure of the parent. One possibility would be to negotiate an arrangement in which the branch=s deposits would be covered by the home country=s deposit insurance arrangements. An alternative would be to organize a local deposit insurance fund, perhaps privately funded, in which international banks would be required to participate.

7. Approaches to financial market integration.

If it is accepted that a greater degree of financial integration would be desirable, the question arises how to

achieve it. We discuss three potential elements of an approach:

- v Encourage the establishment of branches by international banks domiciled in countries with a strong supervisory framework;
- v Create a regional structure to facilitate the production of the required regulatory and supervisory services, and foster coordination of efforts.
- v Consider whether to encourage domestically-chartered banks to expand abroad;

Encourage international branching

International banks bring several sources of strength to the domestic financial system. They bring expertise that may not exist in the local market, and may sharpen competition. Perhaps more importantly, they bring to the local market the financial strengths of the parent institution. Here branches offer an advantage over subsidiaries to the host country, for while subsidiaries are legally separate entities that can be, and have been, cut off by their parent institution during a crisis, branches are an integral part of the parent institution. And, because they are regulated and overseen by home country regulators, bank branches are a means of "importing" the regulatory and supervisory services of its home-country government, including its lender-of-last-resort and deposit insurance functions.

How should the establishment of international bank branches be facilitated? One approach would be to attempt to harmonize as much as possible regulatory and industrial structures of the many countries involved, then permit banks from these countries freedom to do business in different countries under common ground rules. This approach has some appeal, but it is likely to prove unworkable, as efforts in a similar spirit proved unworkable in Europe in the early 1980s. It would almost certainly be impossible to coordinate an agreement among the various countries on the appropriate, harmonized structure. The difficulties are in part logistical, and in part political, as many differences in bank regulatory and market structures are politically contentious matters. And it may be difficult or even counterproductive on economic grounds suddenly to harmonize banking structures by fiat, because different systems of corporate governance have grown up around different national banking systems. One can imagine banking systems, nonbank financial markets, and the associated systems of corporate governance gradually converging to a common pattern, but would quite likely be counterproductive to try to harmonize banking systems while other aspects of the financial system remain diverse.

An alternative approach would take a page out of the European book. The European Union has managed to

eliminate barriers to intra-European movement of banks, despite the persistence of important differences in national banking structures, by seeking to harmonize only the most essential elements of the regulatory and supervisory framework, agreeing to grant banks chartered in any EC country permission to operate in the host market according to the same rules that they must follow in the home market, and trusting home-country supervisors to oversee their activities.

A country in Latin America could accomplish much the same by declaring that branches of banks whose supervisor is one of a list of those considered sufficiently capable of overseeing their banks' international activities are free to establish themselves and engage in business as they are permitted to do at home. Such branches would be expected to rely upon the financial resources of their parent, and in the event that the parent should run into difficulties, it would be expected to rely upon the home-country authorities. The Latin American host country may want to establish an information sharing arrangement with the home-country supervisors, to ensure that they receive the information that they need to carry out their supervision, but the host country would be relieved of responsibility for supervising the bank directly.

Because it eliminates the need to negotiate common standards or definitions of "adequate" or "equivalent" market access, this approach has the advantage that it is actually achievable. Indeed, it can be carried out unilaterally. Also, as noted above, it facilitates the importation of the parent institutions financial strength, and the home country's regulatory and supervisory expertise and financial resources. However, because it permits foreign branches to carry out their business as they are permitted to do at home, it introduces an element of regulatory "competition", creating the danger that domestically chartered banks will advocate the relaxation of prudential norms from the more stringent levels required by Latin America=s volatile economic environment.

Create a regional structure to support Latin American bank regulation

A major achievement of the International Monetary Fund has been to improve the quality of central banking in Latin America, and other regions of the world. It has done this by sharing technology and expertise accumulated in its activities around the world, by conducting and disseminating policy-relevant research on monetary and financial

issues, and by reviewing policies and providing formal training to central bank staff from around the world.

There is no analogous institution to support banking authorities in Latin America. But the need for such support is at least as great for the region's banking authorities as it is for its central bankers. Such an institution could benefit national authorities by exploiting economies to scale in solving the many common bank regulatory problems facing countries in the region, identifying and disseminating "best practice" in the region, conducting and disseminating policy-relevant research on unresolved problems and new approaches to old problems, and helping to train staff from supervisory agencies around the region. The institution could also provide a useful forum for the sharing of information and ideas about new regulatory initiatives and about economic and financial developments of relevance for bank regulators and supervisors, and a useful interface between national regulatory authorities and other relevant bodies, such as the Bank for International Settlements. Finally, it would be a natural forum to secure regional coordination on banking issues, including coordination aimed at reducing the scope for "regulatory arbitrage" and other potential problems created by increased international integration.

The question arises whether it makes sense for such an institution to be regional in scope, or whether these activities would be better placed under the auspices of a global institution such as the IMF, or an expanded OECD or BIS. Economies of scale may argue for the latter, though in many of the institution's activities there are bound to be some equally important diseconomies of scale well before the number of countries reaches the world total. While there is no reason to discourage initiatives at the global level, they are no substitute for a regional institution. Such an institution would complement arrangements that already exist for industrial economies. And the institution would be more productive if it were able to concentrate on issues that face Latin American economies which, while diverse in many ways, face many common problems, often quite distinct from those faced in, for example, Africa, Central Asia or the South Pacific. Finally, a regional institution is a natural counterpart to the continuing financial and nonfinancial integration of Latin America that has resulted from integration efforts ranging from sub-regional trading blocs to the Miami Summit initiatives.

Should domestically chartered banks be encouraged to expand abroad?

As we argued above, the borders that circumscribe "domestic" financial markets and separate them from international markets have little economic or business rationale, and result instead from the fact that the activities of chartering, regulating and supervising banks require a government with coercive powers, which is found at the national and subnational but not the international level. But the borders are not innocuous; to the extent that they require banks to forgo the diversification of country-specific risks that is afforded by international activities, they make the financial system more brittle, and increase the likelihood that a macroeconomic shock will be amplified by a collapse of the domestic banking system.

If public money is put at risk by international activities of domestically-chartered banks, then there will be a need to supervise their foreign activities, just as there is a need to supervise their domestic activities. International activities do involve some additional risks, against which must be set the benefits of international diversification emphasized above. They also introduce some complications in the regulatory and supervisory process, including the danger of regulatory arbitrage. If the capacity to regulate and supervise banks is low enough so that these additional complications outweigh the potential benefits of diversification, it may be prudent to discouragebanks from expanding their activities abroad until the regulatory capacity is improved. This improvement could be facilitated by the creation of a international facility to assist Latin American banking authorities carry out their tasks, and coordinate their activities with other banking authorities.

8. Concluding remarks

Globalization is a fact of economic life, in nonfinancial and financial matters alike, and most are persuaded that deeper integration in these forms is not only inevitable but also desirable. But whenever several reform agendas are in place, questions of sequencing arise. Recently the view has gained ground that measures aimed at securing a deeper financial integration should be postponed until nonfinancial integration is achieved, because of fears that initiatives in the financial area will be a source of instability. We share the spirit of these concerns, but not the policy conclusions. Our fear is that postponement of initiatives to secure a deeper financial integration will itself be a source of instability, because it will freeze the region into a state of Ashallow@ financial-market integration, in which

international capital flows wash in and out of domestic financial markets that are ill equipped to manage them. We also think that financial integration is complementary to the trade liberalization and regional integration that is on the region=s immediate policy agenda. Deeper and more efficient financial markets, closely integrated with world markets, are required to finance the many investments that will be required to effect the adjustment to reforms of international trade and investment regimes, thus easing the adjustment process.

While the approach to integration that we have discussed would mark a substantial innovation for many countries in the region, we are not starting from scratch, and there are several useful precedents in the region. In particular, the countries that have chosen or had to dollarize their economies have often found that they lack the financial resources to perform the lender-of-last-resort function. This has created strong incentives for policymakers to promote financial integration by ensuring that banks in the domestic market have strong ties to foreign banks, from which they can draw financial strength during a crisis. Panama is an outstanding example of this process, and the resulting integration of the domestic with the international financial system may be part of the explanation for the Panamanian puzzle discussed above. Such financial integration has also been an explicit strategy in Uruguay, where the devastating banking crisis of the early 1980s convinced policymakers to promote the entry of major international banks in the domestic financial market. Today, the Uruguayan banking system is dominated by subsidiaries of major international banks, and is stronger as a result.

Financial integration is no panacea. It is no panacea for financial markets, and even if it were it would be no panacea for development, because financial markets cannot address all of the region=s development challenges. Panama illustrates this for, while its outstanding financial system has certainly benefited the country, it has not transformed it into a development miracle. Since there are no panaceas, policymakers need to set priorities according to the likely costs and benefits of alternative policy approaches, not reject approaches simply because they fail to solve every development challenge.

As we meet, policymakers throughout the Americas are now embarked on a process of defining and implementing the year 2005 goals for regional integration that were called for in the Miami Summit. Those discussions have so far emphasized integration in the areas of trade and investment. Without questioning the importance of initiatives

in this area, policymakers should consider making the achievement of a deeper financial integration a target for earlier, rather than later in the reform process.

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