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FINANCIAL REFORMS AND REGULATIONS

The past 15 years have seen broad financial reforms in industrialized nations as well as in developing countries. These have been an integral part of a general effort to reach more efficient, less unjust economy structures, and have been a first step in the fight against inflation. The result has been greater efficiency in general, but has been especially significant in the development of financial markets.

In Latin American generally, two motives have impelled countries to make important changes in their financial systems, either to respond to a crisis in their banking system, or in an effort to improve the competitiveness and efficiency of their financial institutions.

Each country, has made reforms according to its own particular circumstances, but they all share several basic elements: greater participation of market forces in the determination of interest rates, and in attracting and allocating funds, introduction of new instruments, notable reductions in reserve requirements for bank deposits, higher capital ratios, new approaches to banking supervision, and much less regulation of financial intermediaries.

Changes in regulations have influenced the extent and development of the reforms in each country, as well as the degree of internationalization of financial markets. The innovations that have been introduced have also affected monetary policy and market supervision and regulation.

This paper intends to review and summarize the principal elements of a financial reform. A reform that leads to more efficient intermediation, by reducing market distortions and permitting resources to reflect their opportunity costs, should depend to a greater extent on market forces and much less on discretionary management in determining quantities and prices.

The paper is divided into three parts. The first presents an assessment of financial market operations in Latin America; the second analyzes the principal measures and instruments used in recent reforms in the region, and mentions some of the new problems that have arisen as a result of the new measures; and the third examines the changes that these reforms imply for central banks.

I. ASSESSMENT

Recent changes in the regulation and operation of financial markets in Latin America can be interpreted as a reaction to the crisis faced by many countries in the region during the eighties. This crisis produced three digit inflation, acute financial disintermediantion, and high public sector deficits. These deficits in turn led to increased demand for domestic and foreign financing that resulted in almost complete exclusion of the private sector from bank credits and the capital market, and a huge public and private sector foreign debt.

Financing of government deficits induced high reserve requirements in the banking system, as well as strong bullish pressures on free interest rates, both real and nominal. To these pressures were added the high risk and macroeconomic uncertainty prevailing in these economies.

Although these aspects brought the crisis to a head during the eighties, we must recognize the fact that financial systems in Latin America were seriously distorted long before, and the emergence of highly inflationary situations only helped to make this more obvious.

As well known, the financial market's interest rate is determined by supply and demand. This variable plays an important role in raising and allocating funds. Wrong

signals from an inefficiently functioning market or administrative interventions can lead to improper allocation of productive factors and have a negative impact on productivity.

As in any other market, there are two prices here: the interest rate at which intermediaries receive funds (deposit rate) and the rate used in channelling them (lending rate). The margin between the two is a good indicator of a market's efficiency: the wider the margin, the more efficient the market, and vice-versa.

For example, a narrowing of the differential will mean a reduced lending rate, an increase in the deposit rate, or both. Any increase in the deposit rate will lead to higher savings; a reduction in the lending rate will encourage investment. Either result contributes positively to growth, in the case that investment and savings respond to interest rates.

The greatest contribution that the financial system can make to economic growth is in operating efficiently; any reforms should be aimed to accomplish this objective.

One way of doing this is to try to pinpoint the main obstacles to efficient market operations. These are:

In first place inflation, the inflationary process affects the fundamental characteristics of money, which loses its properties of storage of value, currency unit and medium of exchange.

The consequences is a profound disintermediation process.

Inflation also lead authorities to adopt unrealistic measures trying to stop the process, such as fixing of interest rates, and huge increase of reserve requirements, leading to distorted market operations and changing relative prices.

Generally, behind uncontrolled inflation there is a large public sector deficit, often caused by a lack of political will to limit or reduce the share of the public sector in the economy.

Other obstacles that should be considered as intrinsic to the market are the following:

a) No competitive market. Barriers to entry and departure of the market. Administrative measures restrict the entrance of new domestic and foreign participants. On the other hand, banks are supported explicitly or implicitly to avoid bankruptcies that could affect the system's stability.

b) Restrictions on capital flows. Sometimes interests paid on foreign debt are taxed, artificially increasing costs of this source of funds. Financial regulations are also applied, such as reserves requirements on foreign debt, or special authorizations or permits are required to engage in these kind of operations. taxes and excessive regulations limit the use of financial instruments biasing portfolio selection.

c) Interest rates are determined by administrative decisions. Deposit rates, for financial intermediaries or the public sector, are fixed by the authorities and are reviewed at their discretion.

We should point out that errors that arise when interest rates differ from those one from free market operations are important on factors distribution, and for macroeconomic equilibrium. It is the case when monetary policy validates discretionary decisions. When this is not the case, black markets are encouraged.

Frequently, loans to specific sectors or activities are granted at fixed rates, which in many cases, are big departure from market rates. Under inflationary conditions, this fact, represents large subsidies for the beneficiaries of these credits and, in the long run, pressures on the fiscal deficit.

d) Information on participants in the market and the state of their activities is restricted. It is usually concentrated in the central bank, the superintendency of banks, insurance brokers, or other intermediaries.

By limiting information to the public, the superintendency, or the central bank, or the Treasury, assumes a moral responsibility towards the creditors of intermediaries. These

can always claim that the authorities concealed information needed to evaluate the risk of intermediary's portfolio.

In financial investments is generally accepted that lower risk corresponds to lower returns. Nonetheless, if the depositor or creditor of a financial intermediary does not have enough information to be able to asses the risk incurred. Furthermore, if he thinks the government agency has it, and is no willing to distribute it he has grounds to make it responsible. When investors or depositors feel that the government is responsible for the safety of their assets, they will not care where they invest their money. Their investment decisions will be determined by which bank offers greater returns. For him risk will be the same no matters where he invest.

The foregoing is a deterrent to market efficiency. If banks are not subject to market discipline, they have no stimulus to reduce risks and therefore make efforts to raise cheaper funds.

e) This situation is reinforced if authorities have found formulas is the past to avoid losses to depositors because of bank failures, or if the Government has explicitly guaranteed creditors of financial institutions the recovery of their capital. This could lead to practices contrary to the solvency of the institutions and their capital adequacy. At the end, it could result in a relaxation of prudential rules for granting credit.

As long as the criterion for found raising is payment of high interest rates, borrowing funds will be more costly. Thus, banks will incur in higher risks. The more explicit and undiscriminating the government's guarantee, the more relaxation of credit discipline. In extreme cases, when one or more banks have had solvency problems, the owners have been motivated to transfer funds to their non-banking concerns through unguaranteed "accommodation" credits, at lower than market interest rates.

f) Social objectives have often been given to financial intermediation, especially when all or part of it belongs to the State. If the instruments used for these objectives have achieved their purpose, it has meant distortions in the allocation of funds. This has been the case in compulsory channeling at subsidized interest rates. In many cases these functions have been assigned to development banks. This model, whether applied to commercial or development banks, does no recognize the fact that the purpose of any bank is to make a profit, and virtually isolates it from the discipline imposed by market forces. Nonetheless, financial activities do require discipline through regulation which, under the described circumstances, goes against market forces. Therefore, these will be incentives to evade it which, in turn, will lead to more regulations; this is over-regulation.

g) It is recognized that market distortions, whether due to decisions of the authorities or not, are reflected in greater differences between deposit and lending rates, or else affect public finances through subsidies, as remarked earlier. Some factors that determine higher differentials are situations where monopolies predominate, or when interest earned by investors or depositors is taxed, and this, in the long run, is passed on to creditors. Also, in cases where insufficient market growth prevents debtors from covering specific risks through organized markets, these are assumed by creditors and passed on to customers.

h) In relation to the above, it should be noted that when the Law specialize intermediaries by type of instruments, a certain monopolistic element is introduced. Another market distortion may arise with the application of different regulations to the various types of institutions, e.g. liquidity coefficients or reserve requirements, mandatory channeling, or different capitalization regimes for each one. In these cases, profitability depends more on what type of institution enjoys the softest

regulations and not on the greater solvency or lower risk of the institution itself. This also encourages recording "ghost" operations and therefore the use of legal loopholes.

i) Market interferences are often interrelated; for example, if the government needs financing and interest rates are very high, it can try to obtain lower cost of funds through the central bank, which, if it refuses to increase net domestic credit, will establish high reserve requirements or compulsory investments in low-yield government securities. If these reserves or compulsory investments account for a large proportion of its resources, the bank will tend to offset it with higher prices to customers. This is only possible if banks can impose their price, in this case the interest rate. In other words, they can if they are in a monopolistic position.

If the market is highly competitive, banks cannot fix the interest charged to customers; lower returns on legal reserves or compulsory investments will affect balances and could even result in losses. Therefore, to avoid bank losses they are often granted compensatory privilege in the form of restraints on market competition. Such situations are reflected in the differential between deposit and lending rates.

Many of the obstacles to efficiency in financial markets that we have mentioned in this assessment have been overcome by some Latin American countries through their recent financial reforms, as we shall see in the following section.

II. FINANCIAL REFORMS

Financial reforms pursue an efficient organization of the market as a point of reference. Care has been taken to ensure that money recovers its essential functions. Much progress has been made torward this by reducing inflationary pressures. When the most

important obstacles to market efficiency have been identified, i.e. imperfections resulting from insufficient growth or government intervention, it has been possible to design adequate strategies for each particular case. However, some measures are common to almost all.

Financial markets opening at all levels, have been granted and this has greatly increased the competitiveness of investment financing. The three fundamental aspects of this are:

a) Barriers to entry have been lowered, although almost all legislations retain the power of the central bank or the superintendency of banks to authorize new companies at their discretion; b) wider opportunities for foreign investment, both through the establishment of foreign companies and through sharing capital of domestic institutions, although percentage limits have been imposed in some cases;[1] c) advances have been made in the development of the capital markets, enabling companies to obtain medium and long term investment financing. Facilities for creating investment and retirement funds, and the promotion of insurance companies have contributed positively to this process.

In addition, to reduce market segmentation and specialization commercial banks have been empowered to provide financial services previously restricted to specialized institutions. Thus, through conglomerates or financial groups, or universal banking, a series of services has been integrated that permit them to rationalize customer service and to generate economy of scale.

Greater independence and increased activity in areas that before were not open to commercial banks, together with more flexible regulations for them, and also financial

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1. This is the case in Mexico, where foreign institutions are only allowed to buy a maximum of 30% of stock in commercial banks, limited to Class C stock. Ecuador only permits investments up to 40%. See Martínez Neira (1992).

innovations have increased the markets systemic risk, and this has led to increasingly strict criteria for evaluating the portfolios of financial intermediaries, and voluntary or compulsory creation of precautionary reserves and capital adequacy. On the other hand, sharing of experiences has helped to identify other types of risks, such as those arising from foreign exchange or interest rate fluctuations, and the means of covering them properly.

1. DESIRABLE PRE-CONDITIONS FOR FINANCIAL REFORMS

Most successful financial reform programs have been preceded by considerable progress toward macroeconomic stability and a balanced public-sector budget. However, as shown by the Chilean crisis in the late seventies and early eighties, advances in this sense by themselves cannot prevent severe financial crisis from arising, with all the negative effects on economic stability that it implies.

The lesson to be learned from financial crises in many Latin American countries, such as Argentina, Chile, Colombia, and Uruguay, is that for deregulation and financial liberation to contribute positively to the development of the financial market, they must be accompanied by new and very strict regulations. These must be based on "the rules of the game" of a free market, rather than on the discretionary decisions of authorities.

Risk and profitability are opposite forces in financial instruments. Making them transparent is part of refining the market. Therefore, rules on the capital adequacy of intermediaries, supervision of assets, limits on the concentration of credit in a single account, especially for interlocking loans between closely associated financial

intermediaries and non-financial corporations,[2] diversification in fund raising are elements that determine the degree of risk for customers and are valuable indicators in making a fair evaluation. In an advanced system, the market itself can supply the criteria for this; in less advanced systems, the rules of the game must be imposed and supervised by the authorities.

One of the problems facing authorities when they decide to begin a process of financial liberalization is that the markets are not really competitive; on the contrary, intermediation is highly concentrated, with a few oligopolistic companies controlling almost all activities.

This oligopolistic setup of the financial system must be taken into consideration very seriously before allowing the market forces to determine interest rates, since it could lead to a widening of the differential between rates and consequently, to increased inefficiency. Therefore, as suggested by Pereira and Sundararajan (1990), before freeing interest rates, the authorities must consider these questions: 1) is there enough competition in the financial market? 2) do the monetary authorities have enough instruments and procedures to influence the rate? and 3) are enough transmission mechanisms efficient to allow the interest rate to respond rapidly to changes in monetary policy and the market's key variables?.

So, it is advisable to take measures to improve the competitiveness of the financial system when leaving interest rates up to the free market. Among these are: opening the market to new entrants[3], as well as facilitating exit; eliminating subsidies on interest rates

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2. Diaz-Alejandro (1985) clearly demonstrates this need for regulation in a liberalized financial system: "...even a purely laissez-faire financial system must have some indirect government inputy, such as efficient judicial and police systems to punish fraud, control contract defaults and settle disputes in bankruptcy cases".

3. Not without fully investigating the necessary credentials of the new participants.

for some loans and eliminating compulsory selective credits, standardizing or eliminating reserve requirements for different financial institutions; introducing the necessary changes in regulations to minimize the frequency of bad credits; and allowing monetary policy to depend less on the use of reserves and credit limits, and more on free market operations.

High, idle reserves are generally associated with monopolies, for reasons already mentioned. If greater competition is encouraged, banks will not be able to pass on the cost of maintaining these reserves to credit users, and will have to absorb the loss. This will tend to decapitalize them, with foreseeable consequences. Therefore, before encouraging competition the structure of interest on legal reserves should be taken into account, or banks should be completely or partially freed.

It is obvious that free market operations will be very limited in effectiveness if an organized money market does not exist. Consequently, suitable conditions for it should be established by strengthening an interbank market in which the interest rate can fluctuate freely. It is also important to introduce reliable government or central bank securities to be used for monetary regulation, not for financing the government.

One measure that can be adopted in trying to improve competition in the financial market and reduce its fragmentation is to accept patterns that gradually lead universal banking. We continue with a section on the model for financial groups that has been adopted in many countries of the region.

2. FINANCIAL GROUPS

Latin American countries that have recently introduced financial reforms (Argentina, Chile, Colombia, Mexico, Peru) have adopted the model of financial groups that allows commercial banks to provide a wider range of services. So, a commercial bank can offer

any financial service through its affiliates, but these cannot be offered directly by the bank.[4]

In practice, preference for financial groups over universal banking, is due to the fact that they can establish a more direct, simpler relationship between the risk involved in certain operations and capital and reserve requirements, as well as more adequate supervision for each type of company within the group. Groups can be an intermediate step towards universal banking while information systems and operating models are perfected to correlate the risks implied in different operations with the reserves or capital necessary to cover them.

A group can offer comprehensive financial services because its components act jointly under the control of the holding company. Usually they invest in financial leasing, investment houses, factorage and brokerage houses.[5] These financial conglomerates therefore have a greater capacity to introduce innovations and offer better and more complete attention to customers while reducing operational costs, thus favoring economies of scale.

Latin America has shown a preference for the model of financial groups purely for intermediation and financial information without participation in the risk capital of other sectors, except as short term portfolio investments with no influence on company decisions.

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4. In Brazil, the Central Bank's Resolution 1524 of 1988 permits the operation of various types of institutions under one legal persona, with one account and accounting system. For example, the banking system includes commercial banking, development, investment and real estate operations. See Martínez Neira (1993) for further information.

5. For example, the Mexican financial groups can include; multiple service banks (commercial); brokerage houses; insurance companies; bail bond Co., foreign exchange houses; factorage and leasing companies.

This choice has been an attempt to diminish the risk of company debts being in effect guaranteed by bank funds. In part, this measure avoids the conglomerate's bank credit being used to finance companies in difficulties.

It is also a matter of facilitating risk evaluation for any conglomerate's business, since intragroup transactions, even for companies in the financial area, sometimes present serious problems. The task of supervisors can be made more difficult when the banks participate significantly in the group's nonfinancial company capital, since the banks, are more able to evade regulations and conceal true net worth.

The benefits derived from adopting the financial group model versus a universal banking system are:

a) It is easier to control and regulate conflicts of interest than when different financial services are offered under one roof.

b) The conglomerate can have lower capital costs because it can achieve economies of scale in obtaining financial resources. It also has lower risks because it combines unrelated enterprises, reducing the risk of affiliates' insolvency, since there is the group's financial banking.

c) "Contagion risk" is less because the banks can be prohibited or regulated from channeling a disproportionate amount of assets towards their affiliates' activities, or from subsidizing them. This limits the risk for subsidiaries, permitting them to expand into new areas, increasing the profitability and competitiveness of the group while limiting possible losses. For example in Mexico, the law on the formation of financial groups expressly prohibits commercial banks from having shares in the holding company.

To avoid contagion risk, it should be specified in law that members of the group cannot participate in the capital stock of other members belonging to the same conglomerate.

d) As mentioned by Martinez Neira (1992), it is possible to regulate the solvency of capital groups when they are consolidated and to penalize capital pyramiding, in order to achieve an effective capital adequacy for the companies that make up the conglomerate.

e) The specialization and size of the group enable it to hire, train and develop specialized personnel, which makes it possible to employ more advanced management techniques and reduces the costs that these human resources represent for the conglomerate.

f) More balanced competition between the banks and non-banking intermediaries is promoted, and over-regulation that might affect the banks' non-banking activities is avoided.

Two points made by O'Brien (1988) with reference to North American financial conglomerates should be included in this section. 1) While a conglomerate can isolate its bank from the risks incurred by non-banking affiliates, it could, on the other hand, manage the entire group with one sole risk and yield objective, which is normal because the group has common ownership and management. Thus, if the conglomerate's bank is limited by regulations to maintain higher capital adequacy and lower risk than desired by the group's administrators, other affiliates will possibly be operated with less capital and greater risk. Although the increased risk might not endanger the bank, it could prove to be an advantage for the conglomerate over its non-banking competitors. 2) The financial conglomerate might not be stable in the event that banking activities are strictly regulated while other activities are not. This could be an incentive to the group's administrators to

transfer activities from the most regulated affiliates to those less regulated, in which case the authorities would not be able to justify independent treatment of the affiliates.

3. REGULATION

The new freedom granted to commercial banks has exposed them to greater risks, forcing a change in regulations, with prudent preventive measures, and stricter standards in certain areas such as supervision and capital adequacy.

When we speak of adequate capital for a financial institution, we refer to the capital needed to ensure that in case of bankruptcy, losses will be absorbed by the stockholders, not by the public.

Until a few years ago, the rules for capital adequacy followed by Latin America in general referred to a specified deposit/capital ratio. According to this rule, a commercial bank's capital had to be a minimum percentage of its deposits from the public. This rule does not guarantee creditors in the case of failure, since the deposits cannot be paid with its capital, but with liquid assets, which are not taken into account in the ratio.

At present, in almost every Latin American Country, it is felt that a most appropriate rule on capital adequacy should be based on asset risk/capital ratio. Under this rule, bank assets are duly balanced by risks, so that the higher the degree of asset exposure, the greater the capital protection offered by the bank, must be.

This rule has its origin in the capital adequacy norms agreed on by the Committee on Rules and Practices of Banking Supervision of the Bank for International Settlements better known as the Basle Committee. These norms consider that the ratio between the assets weighted for risk and capital of commercial banks should be at leas 8%. They also

consider as assets some items not included in the balance sheet,[6] and the portfolio risk is taken into account by means different ratios of minimum capital for the different types of assets.

In weighting the asset risk, the credit portfolio as well as the investment portfolio is rated. Portfolio analysis takes into account factors such as a customer's fulfillment of debt servicing, as well as solvency, commercial record and guarantees provided. With this analysis, asset risk can be evaluated and the level of resources needed to balance the risk determined.

In addition, a general provision or reserve should be established to protect the unrated part of the portfolio.

As for the investment portfolio, efforts are made to analyze the solvency risk of security issuers due to market variations, such as exposure risk because of changes in interest rates, foreign exchange risk, and country risk, and to determine the minimum capital provisions needed to cover it.

In the case exchange risk for example, the Basle Committee proposes an 8% capital requirement for the net open position of the bank,[7] allowing a minimum exemption for banks that have little exchange activity and do not deal in foreign exchange at their own risk.

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6. These concepts are part of so-called complementary capital, that includes reserves for unidentified losses, hidden reserves that banks in some countries are allowed to maintain, fixed or financial assets that register a market value superior to book value, unguaranteed debt instruments, etc.

7. The net open position of the bank is calculated by adding the total net short positions in any currency, including the declared currency, and the total of each net position in any precious metal disengaged from the monetary unit.

The Basle Committee decided not to recommend application of international capital requirements to global interest rate risks assumed by banks, considering present requirements to be sufficient.

To spread risk in the investment portfolio, countries of the region have placed special emphasis on limiting the concentration of credits. The Basle Committee considers 10% to 40% of the total capital to be an adequate limit for a sole exposure; in Latin America, individual limits tend to be lower they range between 5% and 30%, and even considering loans with real guarantees, are never above 30%. For individual loan limits, the interrelation of the property of some concerns is also taken into account.

So-called "Risk Centers" complement these norms. These are credit information centers offering the opportunity to consult the level of exposure of the whole system, or of one institution in relation to one customer, and the degree of risk that each financial institution ascribes to him. Several Latin American countries have given legal approval to these centers, to which all institutions of the financial system have access.

It should be pointed out that a study by Cantor and Johnson (1992) found that the U.S. market has rapidly compensated those commercial banks that have made great efforts to improve their capital ratios by adjusting them to the new norms and reducing leverage levels. These banks saw the price of their stock grow to above the average during the last three years (1990-1992).

4. BANK SUPERVISION

a) Supervision of Financial Groups

The appearance of conglomerates has complicated the supervision of financial institutions, especially because of the necessary coordination between different regulators

responsible for the supervision of different parts of the group. Moral risk is also a potential problem, since conglomerates encompass a mixture of regulated and unregulated financial institutions, and quite often the holding company itself is unregulated.

Efforts have been made to isolate banks from contagion risk, although some authors like Cornyn, et. al. (1986) consider this to be difficult for three basic reasons; a) the conglomerate is managed as a unit and errors or bad management affect all affiliates; 2) the market could percieve that a conglomerate does not provide sufficient isolation for the banks, and this could lead to an affiliate's losses causing a run on a subsidiary bank; 3) bank regulators have sometimes treated conglomerates as a single entity in consolidated reports or in the handling of some errors. If the authorities consider the group to be a single entity, then its administrators and creditors can also do so.

Measures taken to isolate banks from the other affiliates have so far been unsatisfactory and; the Basel Committee is currently studying ways to remedy this problem.[8]

Among the most serious problems of conglomerate supervision are the following: 1) determining what funds the group has and whether they are sufficient for the risks assumed, and the observance of limits and other general regulations; 2) uncovering crossed stock holdings that need to be eliminated when determining the real level of group funds; 3) Apportioning responsibilities and coordinating with other supervisory authorities when the conglomerate has headquarters or affiliates abroad, or includes bodies subject to other supervisory authorities, for example banks, brokerage houses and insurance companies and 4) determining the legal responsibility of the group regarding its parts.

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8. See Corrigan (1992) for example.

In general, among the measures recommended for facilitating the supervision of financial groups, is to consolidate the conglomerate's activities in order to obtain an overall picture of the risks assumed and contrast it with the funds at its disposal, scrubbed of double postings. This will provide the information for more exact analysis of the group's stability[9].

In those cases where the conglomerate includes several activities under separate supervision, the above information is very important to coordinate the efforts of the different supervisors. This is especially true considering the difficulty in demanding solvency from each independent institution to cope with their particular risks.

To face collective risk when there is no consolidation implies that the regulation of a conglomerate's activities must specify that it have minimum of funds on hand equal to those required by each set of rules applying to their respective activities. This will provide sufficient solvency for the conglomerate, especially if intragroup balances are monitores and controlled. Note that this would not prevent investments from being channeled into less regulated activities.

b) Supervision of Banks Foreign Branches

With the increasing integration of worldwide financial systems, there is an ever greater need for comprehensive, standardized, and consolidated supervision method. The Basel Committee has proposed basic norms for the supervision of international banking groups and their transnational agencies. Because of ever closer relations among markets and because of the potential systemic risk due to problems within an individual financial conglomerate that could endanger the stability of the financial markets of countries in

9. See Rodríguez G., et al (1992) for example.

which it operates. these rules are geared towards protecting the depositors and the creditors of financial institutions and to protect the efficiency of payments systems.

The minimum norms of The Basel Committee specify that the home country of a bank or financial group with international affiliates must be responsible for the overall supervision. The home country should receive the following information from the host countries about the branches or affiliates of its banks or banking groups: a) all prudential and consolidated financial information on their operations, as well as a confirmation of its reliability in order to check the security and the stability of the bank or conglomerate; b) information about the ability to prevent affiliated corporations or enterprises that could undermine efforts to maintain consolidated financial information or that might interfere with effective supervision of the bank or financial group; and 3) information about how to prevent the bank or conglomerate from establishing branches or affiliates in countries in which minimum norms are not met to its satisfaction.

These minimum rules have been applied in the United States since the end of 1991, and have been included in the general guidelines for the establishment and supervision of bank agencies, branches, affiliates or subsidiaries abroad proposed by members of the Association of Bank Supervisory Agencies of Latin America and the Caribbean.

III. THE CENTRAL BANK AND FINANCIAL REFORMS

1. THE AUTONOMY OF THE CENTRAL BANK AND STABILIZATION

Efforts to achieve stabilization and opennes, or deregulation of the financial system in Latin America can be interpreted as a response to economic stagnation and instability as well as to the low productivity and inefficiency of financial intermediation.

When stabilization programs have been successful, they have been characterized by firm political support which has made it possible for all, or almost all of the economic policy instruments to be aimed at this priority. Monopolistic positions have been reduced, tariffs and other distortions to trade have been eliminated and prices of goods and services have been stabilized by giving preference to market forces. However, during transition periods, there has been an agreement among sectors to ease this process.

These stabilization programs also involve the correction of great imbalances in public sector finances by eliminating subsidies and other government transfers that had proliferated in the past, leading to a more efficient readjustment of relative price structures.

Supported by a strategy such as this, monetary policy is in the best possible position to achieve price stability minimizing economic and social costs.

To the extent that monetary policy is able to reduce the growth rate of money it is probable that it can also reduce the pace of inflation. However, the more inefficient and the more inflexible the productive apparatus of the economy is, greater the social and the economic cost of achieving stability. This is especially true when an attempt is made to reduce very high levels of inflation as has been the case in may Latin American countries.

If, for institutional or other reasons, some prices are relatively inflexible to the stimulus of demand, which is the channel for monetary policy to exert its influence, it must increase contraction efforts to defeat price inflexibility, which could lead to increasingly high levels of unemployment among factors of productivos.

Many stabilization programs that first met with success have later failed when economic and social costs became politically untenable. Opportune action to increase the system's efficiency can lessen these costs and increase the probability of success.

If the political will to combat inflation, exists, monetary policy, which is the most efficient instrument to achieve this goal, for this acquires a superior strategic position. Consequently, the central bank, which is generally in charge of implementing the policy, also gains prestige. In other words, if society gives high priority to price stability, and this responsibility is in the hands of the central bank, this institution must be given the necessary authority to achieve this goal.

This affirms the need to define or redefine the central bank's objectives, since in many cases the charters or goals of these institutions set forth other additional objectives such as maintaining high employment levels or achieving high growth rates. It is widley recognized that monetary policy influences economic growth by bringing about an environment of stability and confidence in which the markets can develop and were the signals given by the price system can serve as reliable indicators for the efficient allocation of resources.

In many cases, and for long periods of time, it was felt that keeping interest rates artificially low or granting loans, sometimes with subsidized interest rates, was the way for monetary policy to contribute to economic development. This obviously proved to be an erroneous concept.

Today there is a wide consensus as to what the objective of monetary policy should be, and it has been included in almost all the new central bank charters. This modified chartersaf Chile, Argentina, Uruguay, Colombia, Peru, Venezuela, El Salvador and, recently Mexico. Specify as the prime objective of the central bank to which all others are subordinate, the achievement of price stability.

Recognizing that the most frequent cause of monetary expansion has been the inability of central banks to refuse financing to the government, the new charters provide for situations ranging from absolute prohibition of government financing to the imposition of narrow limits on doing so. In some cases,it is stipulated that the central bank may

acquire government securities only as a means of monetary regulation (free market operations). This means that the government must satisfy financing requirements through the market, relinquishing cheap financing from the central bank and occasionally assuming the unpopular consequences of increased interest rates

Though less frequently, credit to the banking system also appears as another reason for monetary expansion. Fear of a systemic crisis has impelled many central banks to support commercial banks as a lender of last resort. This has occurred both with, or without, a formal obligation to do so. In Argentina practically all bank deposits were guaranteed; this, added to a general disruption in the countries financial system and encouraged risky if not fraudulent credit practices that brought about a crisis that caused many bank failures. When obliged to make the guarantee effective, the central bank produced a monetary expansion comparable to the one originated by the public sector deficit.

For this reason, the charters also limit the authority of central banks to act as lenders of last resort. Argentina is an extreme case, where this function disappears. In other countries, the bank is limited to acting in very specific cases. Deposit guarantees are also limited and, in general, reduced to minimum deposits. In many cases, the establishment of contingency funds has been anticipated to cover guarantees whenever necessary. These funds are made up of contributions from banks in proportion to their size.

It is clear that monetary policy must not be subject to other economic policy objectives if it is to reach its goal of price stability. It must be independent, and this independence must include its administration and an institutional autonomy that precludes interference arising from the desire to reach objectives in other areas of economic policy. Andres Bianchi (1992), defines central bank autonomy in its simplest and most fundamental form as the fulfillment of a basic premise: "that in the performance of its

functions, the bank neither receives nor need obey instructions from the Executive Branch or from Congress."

Certain conditions must be met to guarantee the central bank's autonomy:

a) The procedure for the appointment and the removal of members of the Board of Directors should not depend on the personal inclination of the Contry's President. It should depend on the approval of other institutions such as Congress, as is the case in the United States.

b) Members of the Board of Directors should be irremovable during their term unless they abuse their authority or are unable to fulfill their duties. It is preferable that their terms be longer than that of the public administration and that all the appointments do not end at the same time, but one by one, so that the complete Board will not be chosen by one single administration.

c) Members of the Board should be subject to strict rules regarding the conflict of interest that could generate any type of dependence between the central bank and the government or the private sector.[10]

d) Government authorities ahould have a seat on the Board, limited to the highest executives of the Ministry of Finance or of any other equivalent Office.

1.1 Solution of Conflicts Between the Government and the Central Bank

It is possible that the central bank's autonomy could, at times, produce a lack of coordination with the government's economic policy. It is therefore advisable that facilities

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[10]. Bianchi (1993) suggests that, besides the foregoing conditions, it would be advisable for Board members to fulfill special technical-professional requirements, or have previous experience in financial or economic spheres, to reduce the probability of appointing unqualified people.

or instruments be legally established to settle differences between the bank and the government.

2. PREVENTIVE SUPPORT FUNDS AND DEPOSIT GUARANTEE FUNDS

For long periods, banks in many countries were forced to maintain very stringent voluntary lending policies due to credit ceilings or high average and marginal reserve requirements. This had unfavorable effects on efficiency and sometimes on returns since credit risk was relatively low because the government or the central bank were the main debtors.

When reserve ratios were eliminated or reduced, as in Mexico, the ability to grant voluntary credit increased considerably. This situation was reinforced by lower government financial needs that reduced the relative attractiveness of public securities, and by stable conditions that favored "financial reintermediation". All of this contributed to an unprecedented expansion of consumer and other voluntary credit, especially to the private sector.

Because of this the systemic risk for investors or depositors as well as the risk for authorities has changed. It is now considered to be higher than before. A series of measures have been taken to meet this situation, with emphasis on prevention; advances have also been made in the application of more objective and rigorous criteria to evaluate institutional portfolios, adequate reserves have been created for estimated credit risk, capitalization levels have been established with relation to asset risks (with recommendations form the Basel Committee), and dissemination of information has been fostered to help depositors in making true evaluations of risks when entrusting their funds to banks. The creation of risk evaluation centers has also been supported for both

particular issues and for issuing institutions. These are integral aspects of preventive supervision based on uniform, reliable and opportune information that limits the central bank's function as a lender of last resort to a bare minimum.

Preventive supervision as understood in the financial reforms of Latin America, aims at supporting or strengthening facilities that follow the rules of the market; because of a lack of indispensable conditions or infrastructure for free market operations, the choice has been made, with increased frequency, to apply regulation models that simulate market facilities.

The central bank's intention to limit its role as lender of last resort and the reinforcement of preventive supervision, would seen to give a larger role to market rules in the organization of the financial markets. However, to achieve effective results, preventive supervision must have financial backing available to help institutions that might get into difficulties.

Such funds have been made up by contributions from authorities and institutions, or only from institutions. Since support for troubled institutions is limited by the amount of its contributions, and given the impossibility of guaranteeing all depositors the reimbursement of their full investments, or even all the depositors of one large bank, there is uncertainty as to the risk offered by each institution. This will induce depositors to evaluate possible returns versus the incurred risk, and to choose according to their preferences. Banks will be able to reduce their risks and take deposits less expensively. These processes help to from an efficient market. If looked at in this way, preventive funds are not in conflict with market efficiency that occurs when disposable funds for bank support are seen to be limitless. In other words, that the government or the central bank guarantees reimbursement to depositors as the last resort.

Another aspect, not always clearly separated from the foregoing, is the guarantee given to small depositors who are unable to judge the risk of not being able to recover their investments. Support in this case is directed to the depositors, not the institutions; it is a corrective instrument, not a preventive one. Once the disaster occurs, and the bank is not able to return all deposits, the depositor can file a claim to recover his investments and income.

A fund similar to the preventive one can be created to take care of this eventuality. The same considerations apply to these funds as to preventive funds. Since such guarantees are limited to avoid distortions in market organization, they have only been grated to very small depositors who cannot make an objective judgment of the risks they incur. Even more, on some occasions it has been suggested that even these depositors be guaranteed proportionately, not completely.

During this seminar, particular cases will be cited and many of the concepts presented here only as illustrations will be examined exhaustively in papers to be given by distinguished speakers.

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