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Financial regulation and supervision in emerging markets: the experience of Latin America since the Tequila Crisis

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Abstract

The paper deals with changes in the regulation and supervision of the Latin American financial sector in the aftermath of the “Tequila Crisis” of 1994-1995. While it finds that both have improved, regulation and supervision cannot resolve all problems; good macroeconomic policy and performance are essential complements. This is especially true because of the procyclical nature of financial activity. The paper presents both regional data for Latin America, contrasting it with other emerging markets, and four country case studies (Argentina, Brazil, Chile, and Mexico). The latter show how individual country characteristics and experiences affect the operation of the financial systems. We close with some policy recommendations.

JEL classification: N26, N46, O54

I. Introduction

The increasing integration of international financial markets poses new challenges to domestic financial markets everywhere, but especially to those in emerging economies. The financial crises of 1994-1995 and 1997-1998 sounded wake-up calls to Latin America and East Asia, respectively, indicating that regulation and supervision needed to be strengthened substantially. Since then, important steps have been taken to improve the rules and ensure their implementation, but financial regulation and supervision do not take place in a vacuum. On the one hand, they must be consistent with domestic macroeconomic policies, and they need a supportive macroeconomic environment in which to operate —as the Argentine crisis that began in 2001 shows only too well. On the other hand, they have to take into account the international rules set by the Bank for International Settlements (BIS), the International Monetary Fund (IMF), and other institutions.

The issue that links this chapter with the others in the WIDER project is that volatility —deriving from international capital flows as well as macroeconomic trends in individual countries— is a leading cause of financial crises. Problems of individual banks can set off chain reactions, both because of the direct links between banks and because of the effects that bank collapses may have on borrowers' capacity to honor commitments. This is the main rationale for the concept of systemic risk. Financial regulation is meant to mitigate systemic risk by imposing restrictions both on the way banks finance their operations and on how they allocate their portfolios. The aim is to insure that they engage in adequate assessment of the risks implied in their activities, make provisions for expected losses, and maintain enough capital to absorb unexpected losses.

There is a good deal of evidence that financial activity is highly procyclical. This problem goes beyond the usual asymmetric information problem and has to do with at least two processes. First, increasing confidence among individual investors tends to generate a self-fulfilling process of change in asset prices. As investors become more optimistic, they try to expand their holdings of such assets at a pace that is far more rapid than that of their supply. Booms in asset prices then tend to corroborate past expectations, leading to further optimism. Individual risk assessment thus changes with the state of collective enthusiasm. Second, banks are also procyclical, even though the chain of reaction is slightly different. Waves of optimism in the banking sector lead to an expansion of lending, which affects the level of aggregate demand and thus the income and cash flow of consumers and the productive sector. In times of expansion, real and financial asset prices increase, and so does the value of collateral. Through these self-fulfilling processes, banks tend to increase their leverage and thus their vulnerability to changes in the variables that affect their risks: economic activity and level of employment (credit risk), borrowing interest rates (liquidity risk), and asset prices (market risk).

This chapter examines financial sector behaviour from the viewpoint of Latin America, although many of the same problems and attempts at solutions can also be found in other emerging economies.[1] Section II begins with a brief look at the structure of the financial sector as a whole, which has changed substantially over the last decade. Despite these changes, banks continue to dominate the sector and so we focus on them in our analysis. In this context, we turn to the regulatory and supervisory systems for the banks and to developments since the Mexican crisis in 1994-1995. We also look briefly at the new international guidelines being proposed by the BIS and the IMF to ask whether they will help shelter the banking systems from the types of shocks they have suffered in the recent past or create additional problems.

In section III, we move to case studies of four of the most important countries in the region: Argentina, Brazil, Chile, and Mexico. Through examination of the experiences of the four, we can get a better idea of how the changes came about and the way in which individual country characteristics affect the operation of the financial systems. These two sections provide evidence that bank regulation and supervision in Latin America have improved in recent years, but much remains to be done. Section IV presents our policy recommendations for the future.

Certainly we are not the first to discuss these topics. On the contrary, over the last few years, there has been a virtual explosion of research on the financial sector in developing countries, including issues of regulation and supervision.[2] We draw on this literature where relevant, in both its theoretical and empirical dimensions, and bring it to bear on the issues under consideration in the WIDER research project.