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GOOD-BYE FINANCIAL REPRESSION, HELLO FINANCIAL CRASH

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Good-bye financial repression, Hello financial crash

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I. INTRODUCTION

This paper seeks to understand why financial reforms carried out in several Latin American countries during the 1970s, aimed at ending "financial repression," as defined by Ronald McKinnon (see for example, McKinnon 1980), and generally seeking to free domestic capital markets from usury laws and other alleged government-induced distortions, yielded by 1983 domestic financial sectors characterized by widespread bankruptcies, massive government interventions or nationalizations of private institutions and low domestic savings. The clearest example of this paradox is Chile, which has shown the world yet another road to a de facto socialized banking system. Argentina and Uruguay show similar trends, which can be detected less neatly in other developing countries, including Turkey. Indeed, even in the United States some worried observers have warned against the dangers of pell-mell deregulation of commercial banks (see Kareken 1981).

The paper will first review dilemmas posed by intrinsic imperfections of any financial market, and will look at legal prerequisites for the reasonably efficient operation of those markets. Then it will examine the stylized facts of some Latin American experiments in financial liberalization, particularly those carried out in Southern Cone countries (Argentina, Chile, and Uruguay). Finally, alternative ways of organizing domestic capital markets under Latin American conditions will be discussed; policies regarding the links between domestic and international financial markets will also be considered.

II. PECULIARITIES AND DILEMMAS FOUND IN FINANCIAL MARKETS

Are banks special, and really all that different from butcher shops?

Neither type of firm is exactly like the textbook idealization of the atomistic firm operating in a perfectly competitive market, where spot prices summarize all information relevant for buyers and sellers of the product. Customers at a butcher shop will not only look at price, but will also attempt to ascertain quality; in some countries they will be aided by government-established quality categories and certifications. Breakdowns in the trust consumers have on their butchers or on government certification, say because of rumors regarding meat tainted by poisonous substances, could produce a kind of "run" on butcher shops, and widespread failures among them.

The comparison is surely being forced. A butcher will seldom turn down a customer who wants to buy with cash everything in sight at the price announced by the butcher (he will just make sure the cash is not counterfeit); a banker will surely not lend all a customer wants to borrow at the going interest rate. The former is a spot transaction; the latter involves a promise to repay in the future which may or may not be sincere or wholly credible. Enforcing the loan contract will involve costs, and even with speedy enforcement the bank may be unable to get all of its money back. The bank will incur costs to explore the credit-worthiness of borrowers; the butcher will not care much for the reputation of cash-carrying customers. There is no humanly possible way of devising a fail-proof system of finding out the true intentions of borrowers, so lenders are likely to end up rationing credit, i.e., putting a ceiling on what arms-length customers can borrow, regardless of their willingness to pay higher interest rates (see Stiglitz and Weiss, 1981).

Financial intermediaries rely on borrowed funds; owners of those institutions typically invest their own capital only in amounts

which are a small fraction of their total lending. A depositor in a bank will have the preoccupations a lender has when eyeing a borrower: will I be able to get not only the promised yield but also my money back as specified in the legal contract? In a totally unregulated system the rational depositor will attempt to process a great deal of information regarding financial institutions, balancing expected returns versus risks of not obtaining back his funds as promised.

One can imagine a world in which all financial intermediation is private and without any direct government regulation. The informational imperfections would be partly offset by investments in information gathering by lenders and depositors; with the passing of time reputations would be built up. Balance sheets of financial intermediaries would be widely available and closely analyzed. It is even conceivable that possible economies of scale involved in the processing of information may not be so large as to impede large numbers of financial agents, assuring some competition among them. Unexpected shocks and informational failures in this economy could of course lead to bankruptcies of some financial intermediaries; an informed public presumably would know the source of such events, so there would be no ripple effects contaminating sounder institutions. One would expect to find a rich risk-return menu available to savers in this world, which would also generate an unregulated stock market for those preferring equity arrangements for obtaining or investing funds. Concentration of economic power, in the form of "economic groups" and conglomerates, would presumably exist only if there are economies of scale to yield social benefits, with free entry checking monopoly behavior. The market rate of interest would hover around the natural rate.

Note that even a purely laissez-faire financial system must

count with some indirect government inputs in the form of an efficient and fair judiciary and police system to punish fraud and to handle the enforcement of contracts and the settlement of disputes and bankruptcy cases. And behind that one must presumably have a polity generating such a judicial and police system, and a body of contract, antitrust and bankruptcy laws which are regarded as fair, efficient, and enforceable. Financial agents feeling a temptation to cheat on their contracts or give false information must know that such behavior will have very high costs; they must also know that even if they flee their country the long arm of the law is likely to reach them abroad. Governments in this world must be expected not to change nor corrupt these rules; domestic private citizens must not only believe in the stability of this system, but also believe that other citizens also have that belief. Foreign financial agents, when dealing with those of our country, must not expect to have these rules changed when things go wrong for them; foreign financial agents dealing within our economy would presumably be subject to the same rules of the game as our financial agents.

Even among those who find a predominantly laissez-faire financial system not only imaginable but also a desirable goal of policy, there are differences on how to organize the underlying monetary system. Some take for granted that the government will have a monopoly in the supply of cash and coins. Aware of the macroeconomic instability which could be generated by sudden changes in the public preferences between cash and the demand deposits supplied by banks subject to fractional reserves, as during the early 1930s in the United States, these observers would impose 100 percent reserves on banks supplying those deposits, while leaving the rest of the financial system unregulated.

(See Friedman 1959). In this view, a significant difference exists between money (cash plus demand deposits) and other financial assets. Other observers would carry a laissez-faire policy even into cash, eliminating the government monopoly, and leaving individual agents free to choose among all potential suppliers of cash, including foreign governments. In this approach there would be no need to impose reserve requirements on banks, which would be totally free of government regulations. The money supply would presumably adjust to real needs, while price and wage flexibility would maintain macroeconomic balance (see Hall, 1982).

The laissez-faire vision also has (at least) two variants regarding how the unregulated domestic economy should manage its exchange rate. If the country is large enough, those giving the government a monopoly over the money supply advocate a freely fluctuating exchange rate, with no restrictions on international trade nor on capital flows. If the country is small (with the borderline between large and small left fuzzy), even money-monopolists favor some form of fixed exchange rate system. For politically turbulent nations, a variant of the laissez-faire vision in small countries would do away with the local central bank, i.e., no national could be trusted with the money monopoly, which would be turned over to a presumably benign and responsible foreign government, as in the cases of Panama and Puerto Rico.

No industrial country has come close to the laissez-faire vision, at least since the 1930s. The government monopoly over cash has been maintained, while banks have been regulated and subjected to fractional reserve requirements. In the United States, an explicit federal deposit insurance was introduced during the 1930s and maintained since then, eliminating old-fashioned "runs" on banks. Like any other insurance scheme, deposit insurance is vulnerable to moral hazard consequences,

i.e., it induces depositors to think that "one bank is as good as another," and leads bank managers to undertake riskier loans. To avoid such insurance-induced risk-taking, supervision over bank portfolios has accompanied deposit insurance. Indeed, the Federal Reserve holds impressive discretionary powers regarding the lending policies of commercial banks, and over their liquidation or merger, if banks are found to be in trouble. Those discretionary powers, however, are subject to review by the Congress and the courts. Vigilance has been exerted by the Federal Reserve to keep non-banking companies from owning or controlling banks. While a trend toward bank deregulation has occurred in the United States during the 1970s and early 1980s, few expect an elimination of deposit insurance, or of the prudential and ownership controls.

Other industrial countries, such as Japan and those in Western Europe, are even farther away from the laissez-faire vision for the financial system than the United States. In several of those countries interest rates are also controlled or supervised by monetary authorities, and international capital flows are regulated. None relies on just price and wage flexibility to seek macroeconomic balance. (Note that those advocating a fixed-money-growth rule are typically as skeptical of the speedy workings of price and wage flexibility to maintain macroeconomic balance as Keynesian economists.)

Finally, it is difficult to find small and open countries which have given up monetary sovereignty after tasting it. Politically sovereign countries using other countries' moneys, or "permanently" committed to a fixed exchange rate and unrestricted capital mobility with a monetary "big brother," usually have come to those arrangements as part of a transition from a colonial status, and it is moot whether the arrangements are regarded as really permanent or only as a step in monetary learning

by doing, a step which had to be accepted to placate special internal and external interests rather than taken after a thoughtful consideration of national welfare.

III. NOTES ON THE FINANCIAL HISTORY OF LATIN AMERICA AND SOUTHERN CONE EXPERIMENTS.

While the financial history of Latin America remains to be written, it appears that by the 1920s most countries had succeeded in establishing commercial banks of the (then) traditional sort; several countries carried out banking reforms during those years following the advice of Professor E.W. Kemmerer, of Princeton University, and of visitors from the Bank of England. The banking system of South American countries already included institutions owned by national and provincial governments; Argentina, for example, had an important government-owned mortgage bank and several other public banks. The late 1920s were characterized in most Latin American countries by fixed exchange rates, convertibility and price stability; domestic interest rates were closely linked to those in New York and London. Although there was no "financial repression," critics pointed out to a lack of medium and long-term credit, particularly to finance industry and non-traditional agriculture. Domestic stock and bond markets were small; only Argentina seems to have had a promising formal domestic financial market, dominated by mortgage paper.

The 1930s brought exchange controls and the expansion of government financial institutions, which at the height of the crisis proved their usefulness in decreasing the incidence of panics and runs; the massive bank bankruptcies which occurred in the United States during the early 1930s were not witnessed in the large Latin American countries, apparently thanks to the presence of state banks plus an activist policy of rescuing most private banks in trouble. By the 1940s many

countries had development banks granting medium and long term credits to non-traditional agriculture, industry and construction. Those credits, at least during the 1930s and early 1940s, seemed to have been granted at interest rates still ahead of domestic inflation, or at least not too far behind it, and in most cases contributed to an upsurge in capital formation.

By the 1950s, however, it was clear that in South American countries experiencing inflation the development banks created to solve one form of market failure (lack of long term credit for socially profitable non-traditional activities) had led to another, i.e., a segmented domestic financial market in which some obtained (rationed) credits at very negative real interest rates, while non-favored borrowers had to obtain funds in expensive and unstable informal credit markets. Public controls over the banking system typically led to negative real interest rates for depositors. "Financial repression" became an obstacle to domestic savings and their efficient allocation, and financial intermediation languished.

In inflation-prone countries, financial reforms were introduced during the 1960s in the form of indexing of some loans and deposits; those involving the housing market were a particularly popular field for these new policies. Post-1964 Brazil is the clearest example of a sustained effort to revive the domestic financial system and domestic savings using a number of indexing devices, but maintaining close government supervision of financial institutions and of interest rates charged in formal markets. The results of the Brazilian reforms have been mixed: domestic financial savings have been encouraged relative to the pre-1964 situation, in spite of continuing inflation and the new policies supported impressive rates of capital formation. But attempts to encourage a significant stock

market have failed, and the financial market remains heavily dominated by public securities. Private agents have shown reluctance to offer indexed securities. Credit to some sectors, such as agriculture, has been heavily subsidized. Brazil has also retained controls over the links between domestic and international financial markets, while following a passive crawling peg exchange rate policy, with sporadic jumps and other innovations.

Southern Cone countries, coming out of sundry populist experiences around the mid-1970s, undertook financial reforms going beyond those of Brazil in a laissez-faire direction. Post-1973 Chile provides the clearest example of this type of financial liberation. That experiment started with a fully nationalized banking sector; a first task was to turn banks to the private sector. This was done by auctioning them off or by returning them to previous owners; apparently little effort was spent on investigating the banking credentials of new entrants. At an early stage interest rates were freed and "financieras" were allowed to operate with practically no restrictions or supervisions; early bankruptcies around 1976-1977 of the more adventurous and unregulated "financieras" led to the establishment of minimum capital requirements for entry. Authorities repeatedly warned the public that deposits were not guaranteed, and that financial intermediaries, like any other private firm, could go bankrupt; it was explicitly stated that there would not be a "bailing out" of banks and other financial intermediaries.

During 1977 it became apparent that an important bank (the Banco Osorno) was in serious trouble. The authorities, fearing that its bankruptcy would tarnish external and internal confidence on Chilean financial institutions, intervened, and rescued depositors and the institution. Apparently, the fear that external loans would decrease

if the Osorno were allowed to go bankrupt was the crucial argument for intervention. Naturally, fresh warnings were issued that, from then on, financial intermediaries would not be rescued. At that stage practically no inspection or supervision of bank portfolios existed. One may conjecture that after this event depositors felt, de facto, fully insured and foreign lenders felt that their loans to the private Chilean sector were, in fact, guaranteed by the state.

During 1979 the Chilean economic authorities started a process expected to culminate in a pseudo-exchange-rate union with the United States (see Corden 1972). The nominal exchange rate was fixed in July 1979, and restrictions over convertibility and capital movements were relaxed; by 1981 those restrictions had been considerably weakened, and Chile witnessed a massive capital inflow. Presumably the hope was to make lending to Chile subject to no more currency risk than lending to Puerto Rico or Panama; the nominal exchange rate was supposed to last "for many years." Some of the economic authorities dreamed with doing away with the national currency altogether, but feared that the military may not wish to go that far.

The theoretical underpinnings of these policies included an extreme version of the monetary approach to the balance of payments, plus the hypothesis that financial markets, domestic and international, were no different from the market for apples and meat. Voluntary financial transactions between private agents were their own business, and presumably Pareto-optimal. Indeed, the nationality of those private agents was regarded as almost irrelevant. The then Director of the Western Hemisphere Division of the International Monetary Fund put it this way at a meeting held in Santiago de Chile during January 1980:

"In the case of the private sector, I would argue that the difference between domestic and foreign debt is not significant--barring governmental interference with the transfer of service payments or other clearly inappropriate public policies--if it exists at all. The exchange risks associated with foreign borrowing are presumably taken into account as are the other risks associated with borrowing, whether it be from domestic or foreign sources. More generally, private firms can be expected to be careful in assessing the net return to be derived from borrowed funds as compared with the net cost since their survival as enterprises is at stake." (See Robichek 1981, p.171).

The same author went on to argue that overborrowing by the private sector, even with official guarantees, was very unlikely, provided official guarantees were given on a selective basis; only public borrowing on international financial markets was regarded as posing the more serious debt service risks (see Robichek 1981, p.172.)

Convergence of domestic inflation and interest rates toward international ones proved to be a slow process, during which the fixed "permanent" nominal exchange rate yielded great incentives for private capital inflows into Chile: during 1981 the current account deficit reached an astonishing 14 percent of Chilean Gross National Product, while domestic savings appeared to collapse. The process of financial liberation had also led to a widely noted concentration of potential economic power in the hands of a few conglomerates or economic groups, which combined financial and non-financial corporations. Before 1981, the official view seems to have been that those economic groups must reflect some economies of scale, and could be regarded as one special type of butcher shop, disciplined by free entry and other competitive pressures. Their allocation of credit resources, often heavily loaded to companies associated with the group, was presumed to be more efficient than that which government bureaucrats could achieve.

As late as March 1981 international business publications were

writing that "Chile's free-enterprise banking environment" was proving to be a powerful magnet for foreign banks, and that more entrants into the thriving sector were lining up. (See Business Latin America, March 11, 1981, p.79.) By June 1981 the same publications were noting with concern the cessation of payments on local credits by CRAV, a Chilean sugar company, as well as other blemishes on the economic miracle, but argued that "the problem areas pose no immediate threat to growth" (Business Latin America, June 3, 1981, p.173.) Following the CRAV news, the Central Bank supported financial institutions to stem incipient "runs." By November 1981 the position of two important private Chilean banks and several financieras became critical: they were "intervened" by the Central Bank. Further interventions of financial intermediaries occurred during the first half of 1982; rather than harsh bankruptcy proceedings, these actions apparently involved a generous expansion of credit to the private sector. Between the end of December 1981 and the end of June 1982, domestic credit in Chilean pesos expanded by 41 percent; of the net increase in domestic credit, 92 percent went to the private sector (see International Monetary Fund, 1983, p.118-119, lines 32 and 32d).

By late 1981 and early 1982 Chile was also feeling the full force of the international economic crisis, and discovering that it was not a "small country" in international financial markets, in the sense of being able to borrow, in either public or private account, all it wished at a given interest rate, even including a generous spread. Pressures mounted on the already overvalued nominal exchange rate, fixed since July 1979; in June 1982 the unthinkable devaluation was carried out in haste, initiating a period of experimentation, which has included clean and dirty floating, a crawling peg, multiple rates, and a tightening up of exchange controls.

The official exchange rate rose rapidly from 39 pesos per U.S. dollar to a range of 74-80 pesos by January 1983; the free rate went substantially above official quotations. Those who had dollar debts were placed under stress; financial difficulties were aggravated by a drop in real Gross National Product of about 15 percent during 1982. The Central Bank undertook rescue operations of banks and other financial intermediaries during the second half of 1982, to avoid a breakdown of the financial system. In January 1983 a controversial, massive intervention of banks, other financial intermediaries and private corporations took place, leaving the government in control of a good share of the Chilean corporate sector, as well as of its domestic and foreign debts. During the first quarter of 1983 it was unclear how far this new wave of interventions would go, nor how would the government go about disposing of the intervened assets and liabilities. Many of those linked to the intervened banks and associated companies, including ex-Ministers of the Pinochet regime, charged that the January 1983 measures by the Central Bank and its now active superintendency of banks were unnecessary, arbitrary and politically motivated, hinting that rival economic groups stood to profit from the measures. General Pinochet himself took the lead in charging the troubled economic groups with a number of sins, including betrayal of the General's good faith.

Whatever the merits of these charges and countercharges, it was clear that the domestic financial crisis in Chile had questioned not only the future of many existing banks and corporations but also the rules of the game as they had been understood during the years of the "Chilean miracle." The opaqueness of the intervention procedures, and of the announced processes to settle the tangled web of inter-company

and bank debts even raised questions about the regime's respect for property rights or at least its willingness to provide effective mechanisms for the efficient exercise of those rights.

The 1982-83 breakdown of rules, and the reliance on discretion by Chilean officials extended to the handling of private external debts. In contrast with other heavy borrowers, such as Brazil, a large share of the pre-1982 capital inflow into Chile went directly to private banks and corporations, borrowing abroad without government guarantees. Indeed, both private borrowers and lenders were warned by government officials that they were on their own, and that such debt could in no way be regarded as a Chilean national debt. In spite of these ex-ante announcements, during early 1983 those private external debts were taken over by the government, which announced its intention to continue servicing them. The private debts have been included in the debt rescheduling being negotiated between the Chilean state and the foreign bank advisory committee for Chile. Apparently the Chilean government caved in under pressure from the bank advisory committee, which argued that it would be extremely difficult for the international financial community to focus its attention on the pressing needs of Chile while an increasing number of companies and their associated Chilean banks were experiencing or approaching a suspension of their payments and subsequent bankruptcy. To make their viewpoint absolutely clear, foreign banks apparently tightened up their granting of very short term commercial credits to Chile during the first quarter of 1983, a technique reportedly used with some success ten years earlier vis-a-vis the same country. The International Monetary Fund, also active in the debt rescheduling exercise, has not publicly objected to this threat to the Robichek doctrine.

In sum, the ad hoc actions undertaken during 1982-83 in Chile to handle the domestic and external financial crisis carry with them an enormous potential for arbitrary wealth redistribution. The lessons private agents are likely to draw from these events are unlikely to be compatible with a reconstruction of a domestic financial sector relying on credible threats of bankruptcy to discipline borrowing and lending. In spite of the ex-post government guarantees to peso deposits, private individuals have sharply decreased their demand for peso-denominated assets, as domestic inflation picks up, and expectations grow that the clearing up of the domestic debt tangle will involve substantial additional inflation. Faith in orderly judicial proceedings to clear up debts and claims on assets appears to be quite low; stories abound of debtors fleeing the country, and of petty and grand financial chicanery going unpunished. It may be noted that these events have occurred even though the public sector budget deficit was nonexistent or miniscule for several years through 1981, and moderate during 1982. (For evidence on the Chilean fiscal performance, see McKinnon 1982.)

Argentine and Uruguayan domestic financial experiences offer a number of similarities to the narrated Chilean events. In those countries domestic financial intermediation flourished and then collapsed. Major similarities are the following:

1. Whether or not deposits are explicitly insured, the public expects governments to intervene to save at least small depositors from losses when financial intermediaries run into trouble. Warnings that intervention will not be forthcoming appear to be simply not believable.

2. The Central Banks, either because of a misguided belief that banks are like butcher shops, or because of lack of trained personnel,

neglected prudential regulations over financial intermediaries. Not surprisingly, the assets held by Southern Cone banks and financieras around 1980-81 appeared to have been substantially riskier than those held by similar institutions in the United States or in Western Europe.

3. The new financial institutions in the Southern Cone attracted fresh entrepreneurs and stimulated the creation of new conglomerates and economic groups. While new entrepreneurial blood has an attractive aura, experience indicates that such venturesome animal spirits are better channeled toward non-financial endeavors, where the disciplining threat of bankruptcy could be more credible.

4. In economies characterized by intractable market and informational imperfections, conglomerates and economic groups, even as they correct some of those imperfections, could exacerbate others, particularly via the creation of monopoly power.

5. The freeing of interest rates and the relaxation of controls over financial intermediation will not necessarily encourage intermediation beyond short term maturities. The flourishing of private financial intermediaries in the Southern Cone, even at the height of the boom, was limited to deposits and loans of less than six months duration. Longer term intermediation via banks or bonds, not to mention via active stock markets, remained very weak.

6. While the end of financial repression undoubtedly encouraged certain types of financial savings, its net effect on total domestic savings, and on domestic private investment and its efficiency remain moot. The Chilean private investment record during the 1970s was rather unimpressive, while its record on national savings remained appalling, in spite of the new incentives (see Harberger 1982.) Argentine

performance was not much better; Uruguay seems to have a relatively better record on this account.

7. Foreign lenders take government announcements that it will not rescue local private debtors with non-guaranteed external (or domestic) liabilities even less seriously than depositors take the threat of a loss of their money. The alleged Japanese attitude of not differentiating between the public and private external debt of a developing country appears to have been upheld ex-post as a sounder guide to action than the Robichek doctrine. Foreign banks lending to both the public and private sectors of a country have considerable leverage to convince governments to take over ex-post bad private debts. There appears to be no international referees to keep them from exercising such leverage. The substantive differences between the nationalization of Mexican private banks during 1982 and the intervention of Chilean private banks during 1983 may be less than one would think by reading the editorials of the international financial press.

8. The combination of a pre-announced or fixed nominal exchange rate, relatively free capital movements, and domestic and external financial systems characterized by the moral hazard and other imperfections discussed above set the stage not only for significant microeconomic misallocation of credit, but also for macroeconomic instability, including the explosive growth of external debt, followed by abrupt cessation of capital inflows. Such macroeconomic instability would occur even assuming tranquil external circumstances, but it is of course exacerbated by external shocks hitting economies made particularly brittle and vulnerable by that combination of policies and institutions.

9. While it remains a puzzle why real interest rates in the Southern Cone countries remained so high even during periods of massive capital inflow, it is clear that a relatively unregulated domestic financial system gives no assurance of real interest rates hovering around reasonable estimates of the socially optimal shadow real interest rate. Indeed, the vulnerability and moral hazard imperfections of such a financial system may help explain ex-post the extravagant real interest rates registered in Argentina, Chile, and Uruguay during the late 1970s and early 1980s.

IV. OPTIONS FOR LATIN AMERICAN DOMESTIC FINANCIAL SYSTEMS

Southern Cone domestic financial systems of the late 1970s and early 1980s ended up with a pessimum "middle way": de facto public guarantees to depositors, lenders and borrowers, and no effective supervision and control (until it was too late) of the practices of financial intermediaries. Reform could logically head in two opposite directions: more laissez faire with binding (constitutional?) commitments against future bail-outs, or toward more public controls, possibly culminating in nationalization of the banking system, as in Costa Rica, El Salvador, India and France. Other Latin American countries outside the Southern Cone, such as Brazil and Colombia, have domestic financial systems that, while showing signs of stress during the last few years, have not undergone Southern-Cone-type of crises; their experiences could be useful in sketching desirable characteristics of domestic financial arrangements.

As noted earlier, the credibility of a government commitment to a truly laissez-faire domestic financial system is very low. Firstly, as illustrated in the recent Chilean experience, foreign financial agents

will not accept a separation of private and public debts when a crisis arrives; financial laissez-faire in one peripheral country does not seem viable. Secondly "public opinion," including generals and their aunts, simply does not believe that the state would (nor could) allow small depositors to be wiped out by the failure of banks and financial intermediaries. It may be that private financial agents, domestic and foreign, lenders, borrowers and intermediaries, whether or not related to generals, know that the domestic political and judicial systems are not compatible with laissez-faire commitments which a misguided Minister of Finance or Central Bank President may occasionally utter in a moment of dogmatic exaltation. When a crisis hits, agents will reason, bankruptcy courts will break down; when most everyone (who counts) is bankrupt, nobody is! Thus, even if one believed, a la Hayek, that the externalities and public good characteristics of the domestic monetary and financial system are negligible, one may conclude that the political, judicial, and social infrastructure found in many developing (and developed?) countries conspires against the viability of such a pure laissez-faire financial system. The zealot may conclude that the nation does not measure up to the purity of the model.

So should one move back to good old 1950s style financial repression, extensive controls and perhaps full nationalization of the domestic financial system? It can be argued that a believable alternative system could be designed, avoiding many of the inefficiencies of financial repression while avoiding those of the Southern Cone experience, and blending both public and private financial agents. What follows sketches some features of that eclectic system.

Negative real rates of interest became common in Latin America during the 1940s and 1950s as inflation gained momentum and many monetary authorities maintained ceilings on nominal interest rates offered and charged by the banking and financial system. At that time most South American countries (but not Mexico, Central America and the Caribbean) also maintained extensive exchange controls. Limited international capital mobility also buttressed the taxing of cash balances and financial repression; the then prevalent Keynesian orthodoxy also encouraged these developments. While persistently negative real rates of interest in the formal financial market occurred only when the government imposed rate ceilings and exchange controls, it is not obvious that public regulation and participation in the domestic financial market necessarily had to lead to negative real rates of interest. The Mexican financial system of the 1950s and 1960s, praised by development scholars, contained both public institutions and substantial government regulations. As already noted, the post-1964 Brazilian indexing and other financial reforms could hardly be described as involving a laissez-faire approach. The celebrated South Korean financial reforms of the 1960s were carried out with a high degree of public ownership and control of the formal financial sector (see Gurley et al 1965, p.45).

Assuming that a country intends to maintain monetary sovereignty but that significant, yet not explosive, inflationary expectations persist, there is a strong case for making sure that private agents have available a domestic liquid financial asset yielding a real interest rate which is not far below, nor much above, zero. The inflationary tax borne by currency balances may result from the inability of the fiscal system to find non-inflationary sources of revenues, or it may be simply

a by-product of an inflationary spiral, whose inertial momentum could only be halted by a severe real contraction. Presumably the transactions convenience provided by domestic currency will be enough to generate some demand for it, even under moderate inflation, an assumption supported by South American experiences. But without a liquid and safe store of value denominated in domestic currency, which at least maintains its purchasing power, a national monetary and financial system will have little long run credibility, short of draconian controls. It could also be argued that without such an asset the system would not meet the most elementary tests of social equity.

There are many possible ways to supply such an asset. The banking system, for example, could provide indexed savings accounts; depending on practical considerations, they could be used partly as checking accounts. At least that segment of the banking system would have explicit and full deposit insurance, perhaps only for accounts below a certain (generous) limit; insurance for larger accounts could be partial. Naturally, the use by banks of funds coming from those accounts would be tightly regulated by a flinty-eyed superintendency of banks. Indeed, practical considerations could lead to the requirement of 100 per cent reserves on that type of deposits, to be placed in very safe assets.

Enormous potential power is given by this scheme to the regulatory agencies: it could end up in the total control of credit by the Central Bank. Experiences in Latin America and elsewhere with a public monopoly of credit have not been so encouraging as to make one indifferent to this possibility. Safeguards against the monopoly scenario would include allowance for the supply of alternative financial assets,

by either private agents or decentralized public ones, plus an active Congressional supervision of the regulatory agencies and the public banks. The latter point suggests that democracy, whatever its more fundamental virtues, is an important technical input for a healthy domestic financial system.

Suppliers of riskier financial assets would not have available public deposit insurance but would be subject to less regulation. Nevertheless, these would still include minimum capital requirements, strict "transparency" informational rules (regarding both assets and connections with other firms), and clear "risk-may-be-hazardous-for-your-health" warnings to the general public. After recent experiences it is probably better to proceed cautiously in this segment of the domestic financial market, but not so cautiously as to make it an empty set. Interest rates offered and charged by these intermediaries would be expected to show significant real rates; at least on an experimental basis those rates would not be set by the monetary authorities, but spreads between active and passive rates would be subject to antitrust vigilance (as entry into this sector would not be completely free). Those spreads would depend, inter alia, on possible official reserve requirements; these could be presumed to be quite low for this segment of the market. Both foreign and private institutions would be expected to participate, but entry regulations and antitrust vigilance would be on guard against interlocking directorates among financial and non-financial firms and would lean against the creation of dominating economic groups and conglomerates. Prohibitions against the mingling of financial and non-financial firms, as in the United States' Glass-Steagall Act, appear particularly desirable where markets are relatively small.

Latin American experience, and indeed that of Continental Europe last century, makes one skeptical that private markets alone will generate a flow of financial intermediation high enough to support a rate of long term fixed capital formation which fully exploits available high social rates of return to long term investments. Private uncertainties and skepticism of all sorts, which cannot be easily removed even if one eliminates financial repression, reduce the scope for private long term finance and for stock markets; the latter have continued to languish even when encouraged by various subsidies, as in Brazil. It will be recalled that this was the original motivation for the creation of public development banks in Latin America during the 1930s and 1940s. The need remains to close gaps left in long term capital markets by acute uncertainties found in Latin American societies, and public development banks remain a plausible solution, in spite of the abuses and errors in their management registered over the last fifty years. Not all experiences have been negative; as noted earlier, public mortgage banks obtaining funds by issuing indexed obligations yielding modest real rates of interest and correspondingly pricing their mortgages, have registered important accomplishments in a number of countries. The crucial lessons remain the avoidance of real interest rates too far from plausible estimates of the shadow opportunity cost of capital, plus political mechanisms to check potential abuses of those public agencies.

Decentralized, efficiently-run public financial intermediaries operating together with private intermediaries could play several important functions, besides merely plugging gaps in the long-term segment of the market. As recent Latin American experiences have shown,

confirming the evidence of the early 1930s, during financial crises the public appears to turn to public banks for greater security. Public banks could help focus market interest rates around the social opportunity cost of capital, decreasing instability in real interest rates. Those institutions could channel external funds, helping to keep tabs on the foreign debt and improve borrowing terms. Their operating costs would give evidence and provide a yardstick on reasonable spreads between active and passive interest rates. By providing long term credit to new, non-traditional activities, development banks would eliminate one of the excuses frequently given for extravagant protection against imports. Indeed, the valid cases for infant-industry protection or promotion are likely to be most efficiently handled under Latin American conditions using public credit instruments, suitably priced, rather than by barriers against imports. Needless to say, public banks will not yield these results without a great deal of effort and pressure by those in charge of their management and supervision. Considerable experimentation is also likely to be needed, particularly regarding the establishment of a structure of interest rates compatible with both a vigorous rate of fixed capital formation and a matching flow of voluntary domestic savings.

The real exchange rate, no less than the real interest rate, remains a crucial price for Latin American economies. The Southern Cone emphasis on exchange rate management as an instrument to achieve nominal targets, letting market forces settle the real exchange rate, emerges from recent experience as less successful than the Brazilian-Colombian crawling peg practice, which targets the real exchange rate as an explicit objective of policy. As with the real

interest rate, the correct real exchange rate is not easy to define and calculate exactly, but grossly over- or under-valued real exchange rates, like giraffes, are not so difficult to recognize on sight. "The correct real exchange rate" would be that compatible with expected current account deficits, output levels and long term capital inflows, given commercial and other policies. These are real considerations; what about the role of the exchange rate (and of expected changes in its nominal level) as a crucial link between domestic and international financial markets, and its impact on the capital account of the balance of payments?

Domestic policies targetting real interest rates and real exchange rates will not be compatible with free or untaxed capital movements and unrestricted convertibility, except by fluke (or short of extravagant average levels of reserves). This is not a pleasant conclusion for those familiar with past experiences with exchange controls over international financial flows in Latin America or elsewhere. Limitations on unconditional capital-account convertibility, however, may have greater or smaller inefficiencies and inequities depending on the context in which they are undertaken. A real exchange rate hovering around its long-run equilibrium level will do much to reduce pressure on convertibility limitations; it would be absolutely essential to avoid the temptation of manipulating convertibility restrictions to buttress overvalued exchange rates, as in the past. Note, incidentally, that even without convertibility restrictions overvalued exchange rates can be propped by manipulating the capital account of the balance of payments, i.e., high interest rates went along in the Southern Cone with the atraso cambiario.

The prudential regulatory machinery could be used to discourage volatile international financial flows relying primarily on taxes or tax-like requirements, i.e., via special reserve requirements for certain types of unwanted international financial transactions, as is the practice in several Western European countries. Taxes would also be expected to capture arbitrage profits from borrowing abroad and lending domestically, under "normal" circumstances. Persistent subsidies to encourage foreign borrowing would be a sign that either the real exchange rate or domestic real interest rates have drifted from their equilibrium levels.

Unrestrained convertibility in the capital account is in fact a luxury, desirable in itself, enjoyed only by a handful of countries which have either a very developed or a very underdeveloped domestic financial system. It is neither the usual practice in OECD countries (see Bertrand 1981), nor was it the expectation of at least some of the architects of the Bretton Woods system (see Crotty 1983). So long as domestic currency balances may be burdened by an inflation tax higher than those levied on foreign currencies, some limitations on convertibility are widely perceived as a necessary part of transitional policy package (see for example McKinnon and Mathieson 1981).

The case for some limitations on free capital account movements rests partly on macroeconomic considerations, partly on the need to correct microeconomic imperfections on domestic and international financial markets. Events during 1982 must have put an end to the notion that there are small countries in international financial markets, in the sense that those countries could borrow all they want at a given interest rate. Currency and sovereign risks will

inevitably tilt the supply schedule of foreign funds to any country in an upward-sloping direction, and may even give it a kinkier look, so that there will be a gap between private and social costs of borrowing (see Harberger 1981 for a clear, but apparently unheeded, exposition). Moral-hazard considerations on both sides of the market, or expectations of bail-outs, reinforce the case for home-country supervision of international financial flows; if home countries do not undertake that supervision others will do it for them.

These considerations also cast doubt on the desirability of allowing the domestic financial system to offer deposits denominated in foreign currencies, either to domestic residents or to foreigners. Such deposits sharply curtail the freedom of maneuver of monetary authorities, for the sake of maintaining the credibility and reputation of the banks offering them. (The point is partly applicable to any country whose banks have an international scope, even if deposits are denominated in home currency). The Mexican and Uruguayan experiences suggest that deposits denominated in foreign currencies enhance vulnerability to crises, introducing the likelihood of sharp discontinuities in the rules of the game. At any rate, in general that type of deposit would not be compatible with limitations on capital account convertibility, limitations which would also rule out the feasibility of a totally clean float for the exchange rate, including both spot and future quotations.

V. A FINAL CAVEAT

Recent Chilean experience shows that a balanced budget by itself will prevent neither a serious financial crisis nor acute macroeconomic turbulence. Yet previous Chilean experiences, and those of other Latin

American countries, also show that fiscal extravagance is a sure way to bring about not only economic dislocation, but also the weakening and even collapse of fragile democratic institutions. This paper has discussed neither fiscal policy nor strategies on how to eliminate inflation. Implicitly, it has assumed that Latin American inflations may be sustained by many sources, not just budgetary laxity, and that in most countries for the foreseeable future "living with inflation" will be a more credible policy goal than eliminating it, and that this must be taken into account when designing desirable domestic financial policies, as well as other measures.

Nevertheless, there are inflations (and budget deficits) which no domestic financial system with a minimum of coherence could live with. Examples include inflations which accelerate for more than, say, three years in a row, reaching levels above one hundred per cent per annum, or inflationary rates which fluctuate unpredictably from year to year. Under either circumstance relative prices will become very volatile, and real and financial calculations very difficult. In contrast, the Colombian experience of the last ten years or so provides an example of an inflation which is fairly predictable and relatively easy to live with. Finally, it would be nearly impossible to design reasonable financial systems, in a mixed-economy context, which could be compatible with sustained public expenditures and budget deficits of the magnitude of those registered in Chile during 1971-72, in Argentina during 1974-75, or in Mexico during 1981-82.

FOOTNOTE

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