# Volatile Capital Flows

## Taming Their Impact on Latin America

Edited by
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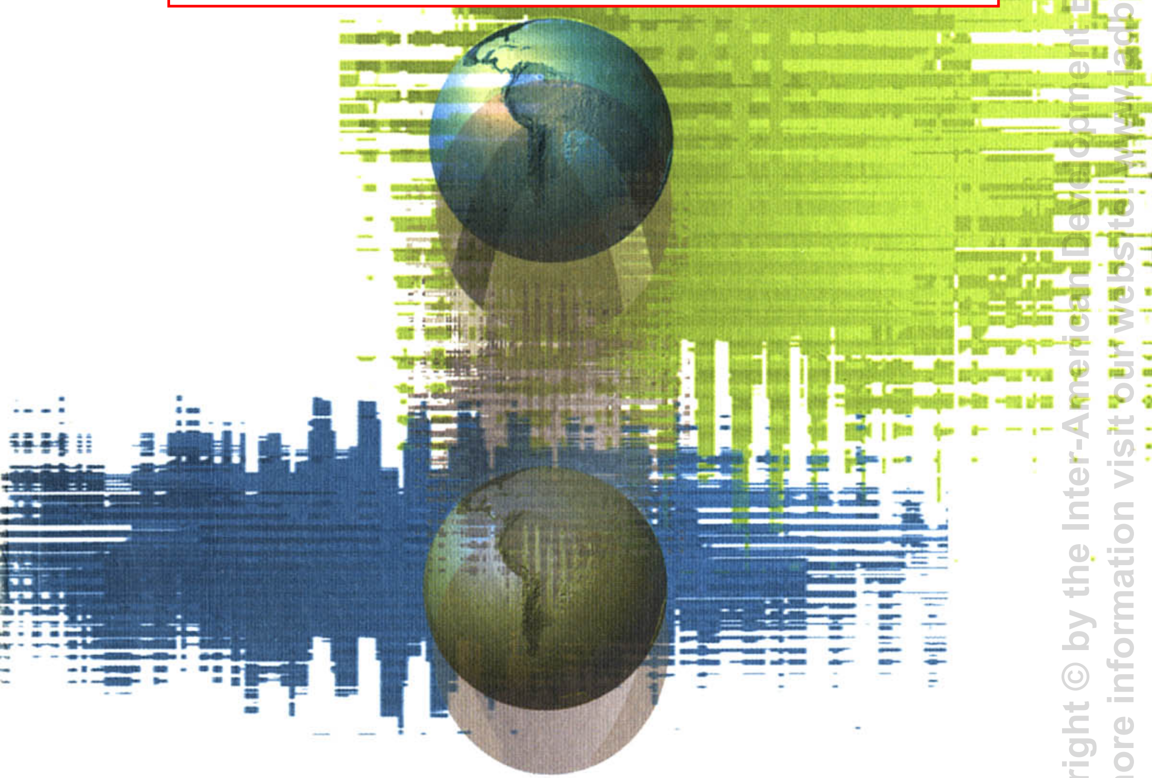



Inter-American Development Bank

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## Arturo C. Porzecanski

As the one panelist who has not had much of a career in the public sector, I will try to provide an unashamedly private-sector, free-market view on the questions raised in the paper. The first of these is whether policymakers can achieve stability in domestic financial markets by relying on supervision of financial institutions. My short answer to that is no. I think that inflows and outflows of capital have to be managed through macroeconomic rather than microeconomic policy.

The financial system is often treated like the messenger who is shot for delivering the message. Yet the financial system is the echo chamber of the economy; one regulates the sound by going to the source of the sound, not by tinkering with the echo chamber. Many of the pernicious effects of the volatility in capital inflows and outflows in Latin America would be much smaller if countries would take seriously two fundamental problems. The first is a shortage of domestic savings: without a larger pool of savings, Latin America is never going to have self-sustaining economic growth, or indeed sustained economic growth at all. For the second half of the 1990s, the countries of the region need to make improving the domestic savings rate a top policy priority.

Certainly, reducing public dissaving by cutting public sector deficits is an important first step, and one that most Latin American countries have taken. But Latin America has yet to take the second and quantitatively much more important step of increasing the pool of private savings. The successful Asian countries differ markedly from the only occasionally successful Latin American countries on this score. Latin America can point to one success story, namely, Chile, where the pool of financial savings was dramatically increased by privatizing the social security system. Similar reforms of pension systems elsewhere are, to be sure, not the only element in a strategy of raising domestic savings, but they are an important element and should be given high priority.

The second problem relates to the exchange rate regime: an important step in promoting the stability of capital movements is to move to freely floating exchange rates. There has been endless discussion in Latin America of the relative merits of different exchange rate regimes, and countries have tried all kinds. But seldom or never in recent memory has a free float, of the kind that the United States, Japan, and Germany now have, been attempted for any sustained period within the region. By a free float I do not mean one in which the central bank is indifferent to the level of the exchange rate, but one in which desired changes are effected through monetary policy, not by imposing or raising reserve requirements on banks or trying to maintain exchange rate movements within a band. The fixed exchange rate regimes now in place have encouraged capital inflows by encouraging all kinds of arbitrage operations. But, as we have seen, in other circumstances they have also encouraged capital outflows.

I believe that high reserve requirements only drive a wedge between deposit and loan rates, encouraging disintermediation, and transfer financial resources to the central bank, where one might question whether they are put to good use. The question of whether reserve requirements are effective or ineffective in protecting foreign exchange reserves against speculative attack is irrelevant under a floating rate regime: the best situation for a government is not to have to protect its reserves or the exchange rate from speculative attack. When emergencies arise, governments have to be able to focus on improving the fundamentals through fiscal and monetary policy while letting exchange rates move freely.

The paper also considers whether bank supervisors can effectively gauge the quality of bank balance sheets from the data currently available to them. I think that the quality of bank assets is notoriously hard to assess from reported data, and not just in Latin America. Needless to say, the same is true for nonbank securities companies. The best solution is for regulators to create risk-adjusted capital adequacy standards, enforce regulations that restrict lending to related entities, reduce large concentrations of risky assets, improve loan classification and provisioning procedures, try to reduce moral hazard dilemmas, and enhance the regulators' own supervisory capacity. While it is true that the data that bank supervisors have available to them leave much to be desired, that is no excuse for not doing what can and needs to be done.

With regard to dollarization, I believe that governments should neither encourage nor impede it. Savers and borrowers, and economic agents in general, should be free to specify contracts as they see fit. The paper also raises the issue of supervision of banking institutions that have subsidiaries overseas. That, too, is a familiar problem, the only solution to which involves international cooperation and common standards among supervisory authorities. Those are the keys to effective supervision, but they are not infallible ones, as we have recently seen.

Would the present crisis be less severe if the market for long-term funds, which remain scarce throughout the region, had been better developed? Again, I think that the only thing that would have diminished or prevented the present crisis is a higher level of domestic savings and a regime of freely fluctuating exchange rates.

My answer on the merits of indexation is the same as for dollarization: I think governments should neither promote nor impede it. Again, efficiency is best served by allowing financial and economic agents to enter into contracts according to whatever terms they see fit. Should bank supervisors encourage entry into banking? Yes, but they should also encourage exit from banking, to maximize competition and efficiency.

Finally, in discussing bank supervision in time of crisis, the paper makes a distinction between a first phase, in which policymakers take patchwork measures rather than face the need to close insolvent institutions, and a second phase, when the need to intervene becomes too obvious to ignore. On the grounds that foresight is never perfect, I believe it is impossible to expect that policymakers will skip the first phase and go straight to the second.

I think many governments have done a great disfavor to their countries by saying that banks will not fail. Bad banks should fail. The two really lasting solutions are, first, prevention, in the form of effective supervision, because prevention is always better than cure; and second, arrangements that allow failing institutions to achieve an orderly exit from the financial industry.

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