Available online at www.sciencedirect.com
SCIENCE DIRECT®
Journal of Financial Stability 1 (2004) 199–228
Journal of FINANCIAL STABILITY
www.elsevier.com/locate/jfstabil

Designing financial regulatory policies that work for Latin America: the role of markets and institutions Views from the Latin American Shadow Financial Regulatory Committee

Pablo E. Guidotti[a,*], Liliana Rojas-Suarez[b], Roberto Zahler[c]

[a] *School of Government, Universidad Torcuato Di Tella, Miñones 2177-C1428ATG, Buenos Aires, Argentina*
[b] *Center for Global Development, 1776, Massachusetts Avenue, NW Washington, DC 20036, USA*
[c] *Zahler and Co., Av. Ricardo Lyon 222 Of. 1701, Providencia, Santiago, Chile*

Abstract

Emerging market economies have undergone an extraordinary period of turbulence in capital markets during the period 1997–2002, and volatility remains a salient feature of the financial landscape. This paper discusses a number of central issues for the future of the region's financial markets. It starts with a brief summary of the reforms undertaken and shows that financial systems still remain fragile in a number of countries in the region. The paper then advances policy recommendations to strengthen domestic financial systems. The analysis and policy prescriptions aim at three areas: 1) the appropriate design of regulatory and supervisory institutions; 2) the role of foreign banks; and 3) how international financial practices affect Latin America.

Keywords: Financial regulatory policies; Emerging market economies; Latin American Shadow Financial Regulatory Committee

1. Introduction

Emerging market economies, and Latin America in particular, have undergone an extraordinary period of turbulence in capital markets during the period 1997–2002. The debt

* Corresponding author. Tel.: +54 4784 0080; fax: +54 4784 0089.
E-mail addresses: pguidotti@utdt.edu (P.E. Guidotti), liliana.rojas-suarez@newyork.dmg.deuba.com, lrojas@iie.com (L. Rojas-Suarez).

1572-3089/$ – see front matter
doi:10.1016/j.jfs.2004.09.006

default crisis in Argentina and market concerns about economic and financial stability in Brazil preceding its 2002 presidential election provide a reminder that volatility remains a salient feature of the financial landscape.

In the view of the Latin American Shadow Financial Regulatory Committee (LASFRC) it is unlikely that the region will see a restoration of capital flows to the exceptional levels preceding the Asian crisis in the foreseeable future, due to a number of factors. These include: relatively high external private and public debt levels in a number of Latin American countries, slow growth in industrial countries, generally tighter risk-control procedures applied by international financial institutions, the unresolved discussion on the role of private sector involvement (PSI) in crisis prevention and resolution, along with increasing awareness of the relative underdevelopment (or weakness) of political, legal, and economic institutions in many countries of the region. At the same time, we recognize that industrial countries' official assistance bilaterally or through multilateral institutions could become less forthcoming in the years ahead. Finally, the recent scandals in accounting practices of US corporations have led investors to reconsider the characteristics of their overall portfolios, potentially increasing the volatility of capital flows towards the region.

Without a sustained improvement in external financing flows, countries in Latin America are facing strong difficulties in restoring economic growth and generating employment. This has led a number of analysts and policymakers in the region and elsewhere to question the appropriateness of the reforms undertaken in these countries during the 1990s, including those in their domestic financial systems. The very significant changes that are taking place in the political scenario in Latin America, which to a certain extent respond to "adjustment and/or globalization fatigue", together with proposals for "reform reversals" are signs of this dissatisfaction.

Since its creation in 2000, the LASFRC has closely followed and analyzed events and developments in Latin America and elsewhere that affect the soundness of the region's financial systems. In its statements, the Committee has concluded that the region's reform agenda is far from complete; accordingly, it has identified a number of areas where substantial additional efforts are needed[1]. Based on its analysis, the Committee believes that reforms in the financial system at the national and international level should be market-oriented, aimed at facilitating the effective working of markets while minimizing the adverse effects of distortions and interference[2]. At the same time, however, the Committee also recognizes that the design of appropriate financial reforms In Latin America requires taking into account the particular features of the region. This implies that in a number of cases adequate adaptation, rather than simple adoption of internationally recommended policies, is better suited to strengthen the safety and soundness of domestic financial systems.

A central lesson of this recent period of capital market turbulence is that financial markets and institutions, domestic and international, play a crucial role in explaining economic

[1] Since its creation the LASFRC has issued nine statements; these can be found at www.claaf.org.

[2] Indeed, although recognizing the major role of adequate government regulation and supervision of the financial system, the Committee has also identified various situations where undue government interference has been an important cause of severe difficulties in some financial systems of the region.