INTERNATIONAL FINANCIAL REDESIGN: A LATIN AMERICAN PERSPECTIVE

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FRAMING THE ISSUE

As the global economy begins to improve, G-20 leaders should now turn their attention to addressing long-term challenges. Rather than focusing on bankers' compensation rules or phasing out stimulus measures, the Pittsburgh G-20 Summit should examine the underlying causes of the financial meltdown and explore ways to prevent future recurrences. Reforming the international financial regulatory framework should be the top priority.

Latin America, a region that needs greater financial deepening, is represented in the G-20 by the presidents of Argentina, Brazil and Mexico. It would be beneficial to them to put forward some concrete proposals to promote greater financial development, not less. A new wave of ill-conceived regulation and red tape will slow down the financial sector development and will hurt the region's opportunity for growth with equity.

POLICY CONSIDERATIONS

What the region urgently needs is a new international financial architecture that would provide greater stability to capital flows. Creating a new arrangement to mitigate the effects of "sudden stops" in capital flows should be a high priority. The consequences of the Asian and Russian crises in 1997-1998 were devastating mainly because there was no lender of last resort to provide liquidity to emerging countries. Facing a negative external shock and a financial crisis, the region underwent a major "adjustment" that only made the contraction deeper.

This time around, the U.S. Federal Reserve, as well as the IMF and the governments of Japan and China, has made available substantial resources to some key countries. However, these mechanisms have not been available for most countries, especially the smaller ones. Also, many of these facilities are designed for governments and central banks, leaving the private sector without a safety net—at least in the international arena. The costs are apparent. Corporations in Latin America have been unable to refinance their external obligations. Without a roll-over facility, many have cut their investment plans. Therefore, in the future, more cooperation will be needed to prevent the loss of access to international financial markets.

While financial deepening and the provision of global liquidity are the top priorities for Latin America, the region should also actively engage in the reform of international financial regulation. The rapid development of cross-border capital flows, combined with the development of near-bank entities and over-the-counter products, not only requires an enhanced level of coordination and communication among regulatory agencies, but also greater diffusion and access to the basic knowledge that an effective supervision demands. The new architecture should make it clear that this particular knowledge is a global public good, which needs to be provided at a very low cost to governments that have lower initial capabilities. Most developing countries need cooperation to train highly competent regulators and supervisors. They also need to retain them, which means upgrading the compensation and incentive schemes.

During the last decade, Latin America has made significant progress in terms of financial regulation and supervision, but that progress is far from uniform. Many countries in the region still have bank-centered supervisory frameworks, even though near- and non-bank financial institutions are becoming an increasing source of systemic risk. A key recommendation is to expand the perimeter of regulation, ideally under a single entity.

Leaders participating in the G-20 meeting should promote measures to reduce the procyclical bias in financial regulations, both in the developed and developing world. This is not new to Latin America: some countries have adopted forward looking provisions that can serve as examples. Countercyclical capital adequacy requirements have been discussed but not established—mainly because more debate is necessary, particularly on implementation. Countercyclical multipliers to variables, such as risk weights, default probabilities, and discounts (haircuts), should consider the product-type and industry of exposure, but also the specific shocks that affect the business cycle and investor and confidence sentiments in each country.

In this context, Latin American leaders must highlight the links between prudential regulation measures in the developed world and financial flows to developing and emerging countries. For example, recent data shows a marked contraction in cross-border lending by foreign banks to Latin America in 2008 and 2009. To a large extent this has been the result of tight inter-bank liquidity and pressure on major banks' capital positions induced by regulators. Reductions in bank lending to developing countries were undesirable, and likely unintended, but they reflect the high degree of interdependence in today's world.

ACTION ITEMS FOR THE G-20 SUMMIT

Leaders from Latin America have much to contribute in the discussions at the Pittsburgh G-20 Summit. They should try to steer the discussion away from bonuses and other compensation matters and toward the issues of liquidity provision and regulation. These issues may have less electoral resonance, but they are far more relevant. G-20 leaders from Latin America should push for progress in these areas to help prevent a future setback in the emerging world.