ROUTLEDGE CRITICAL STUDIES IN FINANCE AND STABILITY

Financial Development, Economic Crises and Emerging Market Economies

Edited by
Faruk Ülgen

ROUTLEDGE

Routledge Critical Studies in Finance and Stability
Edited by Jan Toporowski
School of Oriental and African Studies, University of London, UK

The 2007–2008 Banking Crash has induced a major and wide-ranging discussion on the subject of financial (in)stability and a need to re-evaluate theory and policy. The response of policy-makers to the crisis has been to refocus fiscal and monetary policy on financial stabilization and reconstruction. However, this has been done with only vague ideas of bank recapitalization and 'Keynesian' reflation aroused by the exigencies of the crisis, rather than the application of any systematic theory or theories of financial instability.

Routledge Critical Studies in Finance and Stability covers a range of issues in the area of finance including instability, systemic failure, financial macroeconomics in the vein of Hyman P. Minsky, Ben Bernanke and Mark Gertler, central bank operations, financial regulation, developing countries and financial crises, new portfolio theory and New International Monetary and Financial Architecture.

For a full list of titles in this series, please visit www.routledge.com/series/RCSFS

4. Cycles, Growth and the Great Recession
Edited by Annalisa Cristini, Steven M. Fazzari, Edward Greenberg and Riccardo Leoni

5. Liquidity Preference and Monetary Economies
Fernando J. Cardim de Carvalho

6. Civil Society and the Reform of Finance
Taming capital, reclaiming virtue
Charles McDaniel, Jr.

7. Financial Regulation in the European Union
Edited by Rainer Kattel, Jan Kregel and Mario Tonveronachi

8. Achieving Financial Stability and Growth in Africa
Edited by Stephany Griffith-Jones and Ricardo Gottschalk

9. Financial Development, Economic Crises and Emerging Market Economies
Edited by Faruk Ülgen

Financial Development, Economic Crises and Emerging Market Economies

Edited by Faruk Ülgen

Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2017
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
Names: Ülgen, Faruk, 1963–editor.
Title: Financial development, economic crises and emerging market economies / edited by Faruk Ülgen.
Description: 1 Edition. | New York: Routledge, 2016.
Identifiers: LCCN 2016014249 | ISBN 9781138123755 (hardback) | ISBN 9781315648644 (ebook)
Subjects: LCSH: Finance—Developing countries. | Financial institutions—Law and legislation. | Global Financial Crisis, 2008–2009.
Classification: LCC HG195.F56 2016 | DDC 332.109172/4—dc23
LC record available at https://lccn.loc.gov/2016014249

ISBN: 978-1-138-12375-5 (hbk)
ISBN: 978-1-315-64864-4 (ebk)

Typeset in Times New Roman
by Keystroke, Neville Lodge, Tettenhall, Wolverhampton

Contents

Figures

10 Dollarization and financial development

The experience of Latin American countries

Eugenia Correa and Alicia Girón

Introduction[1]

Dollarization in the 1970s and 1980s, banking crises in the 1980s and 1990s, and the Global Financial Crisis in the first decade of this century have all changed the main parameters of financial competition in the largest Latin American countries (LAc). Financial structures have changed as well, meaning that the financing relationships between banks and domestic firms have too. In addition, market-orientated policies have deeply changed economies, including the role of public credit, the ownership of public and domestic firms, and also the foreign financing of the local affiliates of global firms. It has not been an abrupt change. It has taken time and has adapted to changing political conditions.

The objective of this chapter is to study the main trends in the transformation of financial systems in Latin America in recent decades. It proposes an analysis following three historical stages of great changes: first, the growth of credit from foreign banks and the subsequent "debt crisis"; second, the high levels of foreign credit through bonds and the public debt "bonds crisis"; third, the growth of foreign credit to private firms and the expansion of global institutional investors. This chapter sustains the argument that the local currency–dollar rivalry created dollarization, as monetary policy or as a market trend, which has had direct consequences for the profitability of local firms.

Dollarization has taken different forms: full currency substitution, as in Ecuador, El Salvador or Panama; the denomination of bank deposits and loans in US dollars, which is the most common measure of dollarization; indexing or emission of financial instruments, such as *Tesobonos* in Mexico (1994), or Brazilian public bonds denominated in dollars; external credit to the public and private sectors. The International Monetary Fund (IMF) defines dollarization as "Co-circulation—also commonly known as dollarization—that results when a foreign currency, often the U.S. dollar, used as a means of payment and store of value in parallel with the national currency" (IMF 2010: 57). This chapter takes a wide definition of dollarization. However, what is crucial for its development is the credit expansion in US dollars and competition with local currency credit.

The dollarization of economies has been partly a response to the conditions of investment financing. A traditional problem of the local financial system is that it

has served only in the financing of "goods in transit", as Minsky (1991 [1977]) explained. In the years following World War II, stable growth was possible because of public external debt, along with stable exchange rates and interest rates. However, since the 1970s, dollarization has been the response of liberalization and a condition of financial deregulation. Since then, the process of *pesificación*, or return to the peso, has been partial and temporary when applied. This monetary rivalry has been building a dual monetary circuit, with partial support from the international reserves of central banks, but with significant limitations when the credit cycle becomes unfavourable for exporting firms.

We begin this chapter with a short description of the first wave of credit growth in the dollar, produced by financial opening and credit expansion in the form of syndicated loans from large foreign banks. The chapter supports the idea that the financial crisis in the 1980s originated from financial liberalization and not because of financial repression as one could argue through the analyses of McKinnon (1973) and Shaw (1973). Later, we analyse the second wave of credit expansion, via bonds and securitization, which started in the 1990s, but which extended into the first decades of the current century. The third part studies the two waves of banking crisis and the emergence of global banks' subsidiaries as a result of the weaknesses of domestic banks. The last section shows that the dollarization process – analysed as currency and credit competition – is built through foreign debt and its many liabilities and returns, but also through the growing market for profits in foreign currencies. Minsky's (1991 [1977]) proposal to study local banking systems as institutions which create money for financing "goods in transit", warns about the double monetary circuit, and it is precisely this circuit that dictates the investments and profits of foreign and local firms (Parguez 2010; Vidal and Marshall 2013).

Financial opening and crisis: the first wave of foreign private credit

In the 1970s and until 1981 the LAc were net recipients of loan capital from transnational banks aiming to expand. The rapid growth of domestic and international credit banks in developed countries (between 1970 and 1981) managed to place in Latin America funds worth about US$200 billion (Girón 1995). Those credits were increasingly given with short maturity and adjustable interest rates. The rise of interest rates at the end of the 1970s increased refinancing of the principal and also overdue interest. In just four years, the external debt of Latin America (1978–1981) almost doubled, precisely as a result of rising interest rates. In some countries, growth in total external debt was even greater because of the degree of exposure to private creditors and the concentration of maturities. Such was the case for Argentina, Chile and Uruguay, and to a lesser extent, Mexico, Colombia, Ecuador, Brazil and Venezuela.

However, starting in 1981, creditors stopped the refinancing. The scheme of accepting further debt for payment in order to avoid the suspension of payments reached its limit with the Mexican crisis in 1982. In several LAcs, especially those with the highest debts, the suspension of payments began months later. This was mainly due to creditors staggering the maturities of the credits unpaid on their balance sheets through refinancing. The intention was to manage balance sheets in order to decrease the pressure for more reserves against bad loans, depending on the regulations in force in each country (Correa 1992).

The external debt – contracted in the 1970s – changed the financial systems and the conditions of banking competition. In addition, the largest banks started participating in international financial markets, and also in the syndicate loans lent to their own governments through the Euromarket.

With the suspension of payments from debtor governments, and the dollarization of their domestic balance sheets, the largest banks from Argentina, Brazil and Mexico confronted great market stress and bankruptcies. Besides the rapid growth of external bank loans since the 1970s, domestic financial systems had been undergoing radical changes. With the collapse of the gold-dollar standard, banks rapidly faced new competition in an increasingly international market. In addition, these credit flows also competed with local activities, meaning that lending and deposit rates and deposit instruments were adapted to this financial liberalization. From the 1970s, one could note some crucial liberalization reforms:

1 Authorization to create foreign currency deposits (Argentina, Colombia, Costa Rica, Chile, Peru, Uruguay and Venezuela).
2 Issuance of government debt, making way for public financing in the open market. Its prevalence in the 1980s changed monetary policy (Argentina, Brazil, Chile, Mexico, Peru and Uruguay).
3 Liberalization of interest rates and its connection to international financial market trends (Argentina, Brazil, Chile, Mexico, Uruguay and Venezuela).
4 Establishment and/or growth of foreign non-bank financial companies: leasing, factoring, mutual funds, insurance companies, etc. (Argentina, Brazil, Chile, Mexico, Uruguay and Venezuela).

The debt crisis implied devaluations of local currencies and created banking crises in Argentina, Peru, Chile, Colombia, Uruguay and Mexico. These crises, together with the stabilization and adjustment programmes of the IMF, imposed major changes on financial systems in two forms: first, in the particular forms of bailout designs; and second, in the design of the new competitive environment. Therefore, the 1980s gave rise to structural changes in LAc economies:

1 the growth of state involvement in the financial sector, as a lender of last resort to rescue companies and banks (Argentina, Bolivia, Chile, Mexico, Uruguay and Venezuela);
2 the laying of the foundations for the privatization process and the placement of domestic companies' stock in local stock markets (Argentina, Chile, Mexico).
3 the exchange of debt for shares in companies and foreign investment through the purchase of discounted debt (Argentina, Brazil, Chile, Mexico).

4 multiplication of instruments, sophisticated financial services for large treasuries requiring diversification of their portfolios and assets looking for higher returns and lower risks.

Moreover, the constant pressure to reduce the fiscal deficit (the first point of the Washington Consensus) meant the closure of public funding for development banks which in Latin America had an important place in the overall financial system. Development banks played a major role in financing the imported composition of public investment, intermediating funds in foreign currency for private companies' investments. As Minsky (1991 [1977]) points out, domestic banks only have the conditions of "financing transit-goods". Changes in the amount and composition of funding have had important consequences for policy and economic structures in all LAcs. The significant dollarization of the 1970s was reversed in the 1980s, due to declining external credit. However, the increasing pressure to liquidate loan commitments in dollars kept the LA economies in the dollar credit creation circuit (Parguez 2010).

Capital inflows: bonds markets and foreign direct investment (FDI)

The flow of funds into Latin America and its largest economies was modified again in the 1990s due to financial deregulation in the US market. The decline in interest rates and the expansion of public spending undertaken by Latin American authorities to face a new episode of over-indebtedness was accompanied by a new wave of financial innovation. This also spread to emerging markets. Indeed, it was precisely in those years that this situation was created.

The high performance of various financial instruments, including securities from different latitudes, remained one of the pillars of profitability achieved in US dollars by banks and US funds. This model of financial business reached a temporary limit because of financial crises in Southeast Asia, Russia and Brazil in the late 1990s (Kregel 1998a, 1998b, 2000; Correa 2013).

Capital inflows to LAcs in the 1990s came from new portfolio strategies in international financial markets of non-bank financial firms, particularly as a result of financial deregulation. Institutional investors channelled their investments into some LA countries to take advantage of at least three conditions: the attractive returns on government securities, at least in Argentina, Brazil and Mexico; local firms' initial public offerings, especially in Mexico, Chile, Argentina, Brazil and Venezuela; the interest of domestic financial firms in associating with investment banks in order to participate in the lucrative business of securitization, issuance and placement of bonds and interest rate arbitrage.

Thus, the (public and private) debt in securities grew from 3.4 per cent of the GDP in 1994 to 17.4 per cent ten years later. The high speed of issuance and the profitability of investments in Latin American securities found an early limit in the Mexican crisis of 1994–1995. Even though it was the greatest financial crisis in the history of Mexico, the large volume of portfolio inflows continued.

Table 10.1 Latin American countries: foreign portfolio investment net inflows (billion US$)

	Total Portfolio	*Debt Securities*
1980s	0.4	–0.15
1990s	367.2	281.4
2000s	176.0	80.4
2010–2014	639.2	468.4

Source: Cepal (2016).

It again faced a second and remarkable limit with the crises in Brazil and Argentina of 1998–1999 and 2001–2002 respectively. The third wave of foreign portfolio inflows started with the great financial crisis of 2007, and was driven by the high interest rates on public debt in local currencies, as seen in Table 10.1.

Portfolio investment reached its first high point in 1993, when net foreign portfolio investment reached US$80 billion, its second peak in 2007 with US$80 billion, and its third peak in 2010 with US$144 billion (Cepal 2016). However, the level of profitability it reached was not sustainable. The outflow of dividends and interest payments required the entry of new and increased flows, or a substitution of investors who would accept another level of profitability.

The profitability of Latin American financial markets has depended on both the interest rate spreads with mature markets – and even with other emerging markets – and the exchange rate behaviour, as well as the size and liquidity achieved by the domestic markets. The reform of pension systems was explicitly targeted at improving these last two (Correa 2015).

One of the forces that gave a new boost to the bond market and the placements from institutional investors was the wave of privatizations in the second half of the 1990s. Mainly it was this process of privatization that explains the dynamic FDI to Latin America in those years. This was especially the case in Brazil, Chile, Argentina and Mexico. From 1997 to 2001, FDI flows into LAcs reached almost US$375 billion and the profits remitted amounted to US$93.3 billion, representing almost 25 per cent of the former figure.

This stage of privatizations distinctively influenced the largest banks and non-bank financial institutions, which had been weakened or broken by banking crises in preceding years. This was the case for Mexico, Argentina, Chile, Venezuela, Peru, and to a lesser extent, Brazil. Thus, while foreign banks in the region handled 20 per cent of the total assets of banks in 1994, this figure rose to more than 40 per cent by 2009. In the most recent years, this number has been estimated at around 30 per cent (World Bank 2015a).

Also highlighted in these years was the privatization of the pension funds, especially in Argentina, Bolivia, Chile, Colombia, Mexico and Peru. Systems of intergenerational solidarity had been formed within Latin American countries so that the contributions of active workers funded the retirement of others. With privatization, pension funds were formed, receiving contributions from active

workers, while retired workers continued to receive their income from public budgets. While policies allowing a balanced budget continued, this meant significant reductions in other areas of social spending. In countries with a compulsory private system (Mexico, Chile, Colombia, Peru, among others) pension funds account for nearly 20 per cent of GDP in recent years (International Federation of Pension Funds Administrators 2014). Foreign banks, mainly from Spain and the United States, manage an important part of these pension funds.

The following and remarkable stage of FDI extended growth ran from 2007 to 2014, in which US$1.3 trillion accumulated, along with a transfer of profits of more than US$870 billion, or 67 per cent of FDI.

Thus, in this period, the presence of US dollars in LA economies grew; either with the expansion of global investment portfolios into local securities markets, or through FDI, and even with the well-known foreign debt flows. But the outflows linked to those inflows also grew, as shown in Table 10.2.

Dollarization in the three largest economies increased, even with different financial systems. For example, in Argentina, a Currency Board operated in the 1990s, the Argentine peso was fixed to the US dollar, and the money supply depended on foreign exchange earnings. In Mexico, the largest banks came to be owned by global banks, managing more than 80 per cent of the total banking assets. In Brazil, even with high inflation in the 1990s, bank assets in foreign banks grew to more than 40 per cent of total assets. There are three different processes of dollarization of domestic credit, as discussed below, which continued to develop over the following decades.

The new economic growth cycle started in 2003–2004 and began a period of increasing domestic funding, linked to the rise in prices of raw materials. The decline in international interest rates with the great crisis likewise served to decrease the cost of refinancing debt. As in the 1990s, this new cycle of growth included a significant wave of foreign portfolio investments, but this time in debt securities and mainly in local currencies.

For example, Mexico had between 2005 and 2014 a net foreign equity investment of US$13.8 billion and Brazil more than US$60 billion. In the same years, accumulated foreign investment in debt markets went to US$287.2 billion

Table 10.2 Latin American countries: capital inflows and outflows (billion US$)

	Capital Inflows: FDI, Portfolio; Loans	*Outflows: Rents of Investments and Debt (–)*
1990–1994	269.9	224.9
1995–1999	455.7	339.9
2000–2004	252.1	388.7
2005–2009	831.2	683.5
2010–2014	1903.7	997.7

Source: Cepal (2016).

Table 10.3 Outstanding external debt of private sector (billion US$)

	Argentina	*Brazil*	*Mexico*	*LAc*
2000	25.9	112.6	50.5	183.4
2005	26.3	69.5	32.7	134.9
2010	31.1	184.9	52.5	309.1
2014	50.0	320.2	98.1	559.6

Source: World Bank (2015b).

and US$160 billion respectively. Most of the securities in debt markets are government bonds (Cepal 2016).

This trend came with an important increase in the foreign debt contracted by the private sector, which has doubled in Mexico and Argentina in the last 15 years, while in Brazil it has increased by more than 180 per cent, as shown in Table 10.3.

However, the World Bank statistics offer little help in observing the phenomenon of the dollarization of domestic credit as a result of falling prices of commodities for export, such as raw materials and oil; or the decline in FDI inflows starting in 2014.

The process of dollarization, which entails monetary and credit rivalry, was constructed during three decades (1970s, 1980s and 1990s) hand-in-hand with the model of neo-colonial exploitation of raw materials and energy sources and workers (as a large reservoir for employment in *maquiladoras* [foreign-owned factories] or migration). In the early years of this century, the model was consolidated with changes in natural resource ownership and extraction contracts for the global corporations that are dominant in each sector. These trends are clearly illustrated in areas such as mining, agricultural production, oil and energy, among others (Sánchez-Albavera and Lardé 2006; Correa *et al.* 2009; IAASTD 2009; Zubizarreta 2013).

In turn, the three largest countries have taken different courses in their production patterns. The approach of Mexico, for example, is most related to the expansion of global corporations in the automotive and energy sectors, and to high migration; for Brazil, to the exploitation of natural resources on a large scale in addition to a diversified industrial base widely supported by public funds; and then there is Argentina's trajectory, with an agro-industrial and automotive base, of both domestic and foreign ownership.

However, those three economies, with all their differences, have shown in recent years the economic problems generated by an economic model mainly based on the export of primary goods or the *maquiladora*-type industrial processes that do not strengthen local production chains. The cycle of financial transformations, focused on the growing participation of banks and global corporations, again reached new limits. But as will be shown in the following section, new areas of expansion for asset securitization, based on high-growth economic activities, were still available.

Banking crisis and global banks' subsidiaries

The domestic banking systems of the largest Latin American economies were languishing because of successive banking crises (Ffrench-Davis 2001). Public credit was decreasing too, mainly because of fiscal balance policies that were preventing public banks from accessing Central Bank credit, forcing these to finance themselves at market rates.

The new financial competition in the region's markets, caused by the opening to foreign credit on a large scale and the liberalization of capital markets, created a constant confrontation between different yield structures, interest rates, margins and other important banking and credit prices. The weakening of some domestic banks became banking crises with successive episodes of varying magnitude.

The first wave of banking crises in the early 1980s was linked to the sudden advance of financial liberalization in the late 1970s, which directly created a huge volume of credit liabilities in foreign currencies for local governments. In a few years, domestic banks faced bankruptcy, triggered by currency mismatches and the insolvency of their own governments. Domestic banks were creditors (within banking syndicates) of their own governments which were in default. Banking crises were then observed in Argentina (1980 and 1989), Bolivia (1986), Chile (1981), Colombia (1982), Mexico (1982) and Peru (1983), among others (Lindgren *et al.* 1996; Cepal 2000). As governments and banks stopped having voluntary access to the international markets, their obvious bankruptcy occurred. The role of the lender of last resort in US dollars, like the IMF or US Treasury, and the financial crisis lasted almost throughout the entire decade.

Banking crises in the 1990s were more closely linked to domestic macroeconomic conditions that were responding to the changing expectations of profitability in more open and global markets. These crises occurred in Argentina (1995), Bolivia (1994), Brazil (1994), Ecuador (1995) and Mexico (1994), among others. This second wave of banking crises witnessed massive bank failures, various forms of government assistance, and high fiscal costs. This wave was seen also in Asia, Africa, Central and Eastern Europe. In several of these economies, the crisis prompted a process of growing foreign control of the financial system. According to IMF figures, in Central Europe, for example, foreign control increased from 8 per cent in 1994 to over 56 per cent in 1999. In Latin America, excluding Brazil and Mexico, it rose from 13 per cent to 45 per cent.

This change in ownership of the most important financial firms was not limited to deposit banks. It also included insurance companies and a range of non-bank financial intermediaries that were part of investment banks and brokerages (Mathieson and Roldós 2001). Among banks, the rapid positioning of the two big Spanish banks, Banco Bilbao Vizacaya Argentaria (BBVA) and Banco Santander Central Hispano (BSCH), and of US Citigroup stand out.

The significant growth of global bank subsidiaries in some of the largest economies in Latin America has so far faced obstacles in both Argentina and Brazil. In the first case, the crisis of 2002–2003 and the financial policies that followed have reduced the share of these banks in local assets which had accounted

Table 10.4 The 50 largest banks in Latin America by ownership[a] (%)

	Domestic Private	*Foreign*	*Public*
Argentina	0	0	100
Brazil	45.5	27.3	27.3
Mexico	20	80	0

Source: América Economía (2015).

Note: a The 50 largest Latin American banks from the ranking by assets.

for more than 50 per cent of total assets before the Currency Board crisis. In the second case, it was slowed by the financial policies of leftist governments which strengthened public banks, as shown in Table 10.4, using data from *América Economía* (2015).

Several analyses have been written about the origins of the banking crisis. For example, there are those that attribute them to national behaviour, which is a difficult position to sustain when crises have occurred massively worldwide in recent years. Other explanations are based on the idea that the financial systems in emerging markets are fragile and external shocks can quickly turn into a banking crisis, particularly due to destabilizing macroeconomic policies, including hyperinflation, large devaluations, nationalizations, and everything that undermines the confidence of investors. In particular, systems with inadequate accounting standards, with unreliable judicial–legal frameworks, relatively small intermediaries, short-term liabilities, little financial depth, and poor development of non-bank financial institutions are seen as vulnerable (Rojas-Suárez and Weisbrod 1997).

Financial reforms in the 1990s led to ownership changes in many important financial institutions. However, the proposed benefits for society were not achieved, including a decline in funding costs, greater availability of financing for local businesses investment, better options for returns for savers and a decline in poverty (World Bank 2002).

In addition, a number of the 30 largest banks have partial foreign ownership with the most notable exceptions so far being the largest Brazilian banks. The banks that expanded most in the region have been the Spanish BBVA and BSCH (Vilariño 2001; Ferreiro and Rodríguez 2004), having the largest branch networks and participating in the administration of pension funds; and the US and UK banks, like Citibank, Goldman Sachs, JP Morgan Chase and HSBC.

The criticisms regarding the prevalent financing conditions in the region at the beginning of this century, caused by the policies of openness and financial deregulation, manifested themselves politically and at the national level in Latin American countries. After tough elections, a group of countries had new governments that put aside policies recommended by the IMF and even abandoned its economic and financial supervision, especially those countries that could settle all loans with the IMF.

In turn, the idea that the processes of liberalization and financial openness had led to economic and financial instabilities, banking crises, slowing or no economic growth, rising poverty, etc., was confirmed (Girón *et al.* 2005; Claessens *et al.* 2014).

The IMF kept repeating that liberalization and opening had positive impacts on growth, although it accepted that the empirical evidence in this regard was weak. In any case, liberalization was accepted as a cause of instability when macroeconomic policies have been inconsistent, and particularly when institutional requirements and financial supervision were inadequate. The processes of liberalization and opening up have worsened income distribution, levels of poverty and the conditions of education and health in developing countries (Demirgüç-Kunt and Detragiache 1998; Claessens *et al.* 2014).

The argument sustained here is that financial liberalization and deregulation have created conditions that weakened financial systems. Domestic banks have not been able to expand their offshore activities at the pace that their economies required. This is especially true under conditions of massive capital outflows, or high and sustained returns on capital in domestic markets, and for those domestic capitals that are internationalizing. Again, Brazil has been the only large country to conserve the domestic ownership of its private banks.

During the first 15 years of the twenty-first century, two major trends in the financial systems can be identified. First, financial systems were being restructured in order to limit the supply of local currency funding, in addition to articulated infrastructure development and the working capital of big business. Also, mortgage and consumer credit segments were growing. In great contrast to what was happening in developed economies, bank lending to the private sector in the region has remained at consistently low levels, as seen in Table 10.5.

It may be noted that lending to the private sector in Argentina and Mexico remains below 30 per cent of GDP, whereas Brazil's lending, although showing increases in the last ten years, has been based largely on public bank lending. These public banks in many other LA countries have been participating in only a few activities and have generally decreased their share of domestic credit.

In addition, domestic financial systems are very fragile in the face of massive capital outflows or inflows. In the LAc crises, the common denominator of large capital inflows can be identified in the run-up to a crisis, and has also been identified to preclude subsequent outflows (Ffrench-Davis and Ocampo 2001). The waves of massive capital inflows and outflows occur through bank loans,

Table 10.5 Credit to private sector (local and foreign) (% of GDP)

	Argentina	*Brazil*	*Mexico*
1990	15.5	30.0	16.3
1995	19.7	32.6	25.2
2000	23.2	28.7	11.4
2005	9.6	31.0	16.2
2010	11.6	52.8	24.3
2014	14.4	69.1	31.4

Source: World Bank (2015a).

portfolio allocations in stocks or bonds, or FDI as well. Financial systems, even though they become more liquid and deeper than in the past, remain very vulnerable and defaults can arise because of currency mismatching or the massive increase of non-performing loans. A large wave of capital outflows can create a systemic bankruptcy for both the domestic banks and the subsidiaries of global banks. This is true as long as the governments do not take the decision to regulate these capital outflows.

The net capital inflows to Latin American countries, according to World Bank data, were positive during some years in the 1990s, mainly because of FDI inflows, which were explained by the large-scale privatizations in Brazil, Argentina and Mexico. But from the great crisis in 2007 onwards, those inflows have had high growth, primarily in portfolio placements and FDI, and especially in Brazil and Mexico. The trend of capital inflows (which include loans, portfolio allocations and FDI) and income outflows (which include payments of interest, dividends and profits) changed after the great crisis. There were years of large amounts of inflows to local financial markets attracted by higher interest rates, especially in the government bonds in the deep and strong markets of Brazil and also Mexico (see Tables 10.5 and 10.6).

Since late 2014, FDI and portfolio allocations started to decline, linked to the overall cycle of lower economic growth. Just as Brazil was the largest recipient of capital inflows, now it is the country with the worst recession in the last three years. In fact, none of the largest economies have the conditions to find and develop growing sources of foreign currency flows at the rate at which interest payments on its liabilities require. This becomes especially evident in times of drastic changes in export prices and/or increased demand for dividends and pro-cyclical repatriated profits.

These two major trends in the financial systems have as a common feature the direct link to the way the double monetary circuit has been working: highly

Table 10.6 Latin American countries: capital inflows and outflows (billion US$)

	Capital Inflows	*Outflows: Rents of Investments and Debt (–)*
2001	70.9	77.4
2005	97.7	105.3
2006	117.6	131.2
2007	268.9	152.9
2008	168.7	159.5
2009	178.8	135.3
2010	400.5	195.6
2011	376.4	221.5
2012	359.1	198.4
2013	377.4	193.1
2014	399.8	189.2

Source: Cepal (2016).

Table 10.7 Foreign credit to private sector* (% of total)

	Argentina	*Brazil*	*Mexico*
1995	15.3	3.7	26.9
2000	18.7	14.4	33.4
2005	33.3	18.8	26.7
2007	22.6	10.3	19.7
2008	17.8	8.2	19.0
2009	14.9	9.7	20.6
2010	13.1	9.6	21.7
2011	10.8	9.4	21.7
2012	9.2	11.0	25.1
2013	7.9	13.3	28.2

Source: World Bank (2015a).

Note: *Foreign credit to private sector as percentage of the total credit (local and external) to private sector.

constrained financing in domestic currency coupled with a great expansion of credit in foreign currency.

An indirect indicator of this process is the external credit to the private sector in its relation to domestic credit. During 1995–2003 and 2008–2014, the external credit in relation to the domestic credit in Argentina, Brazil and Mexico was becoming increasingly important, as may be observed in Table 10.7.

In the last five decades, many Latin American countries have seen their financial structures change significantly. These countries have moved from the model that Minsky called "financing of transit-goods" – which was generously funded by public credit (Lichtensztejn 1984) – towards a model based on global banks, securitization and high returns on public bonds. All these changes have not modified the main trends of dollarization, but rather evolved with them.

Dollarization, investment and profits in the "new financial architecture"

The international financial architecture has been one of the recurrent themes that arises every time international financial crises spring up, such as the ones in Asia, Russia and Brazil in the 1990s. Roughly at the time of these crises, several important reports were issued. These include the US Congress Meltzer Report (2000), or the Group of 22 Report (1998) – the association that was created in Washington in April 1998 and presented its Report together with the meeting of the IMF and World Bank in October of the same year. The Goldstein Report (Goldstein *et al.* 1999) and that of the UN Conference on Trade and Development (UNCTAD 2001) were also significant. Relevant books and articles were also written, such as that of Eichengreen (1999).

The great crisis of 2007 once again increased the production of financial architecture reports, such as the Stiglitz Report organized by the United Nations (2009), or the UNCTAD Report (2015). Another important outcome was the creation of the Financial Stability Board (FSB), a multi-institutional organization composed of the finance ministers and Central Bank governors of the G20 countries, the IMF, the World Bank, the Organisation for Economic Co-operation and Development (OECD) and the Bank for International Settlements (BIS). Until February 2016, the Governor of the Bank of England chaired this organization and it was the most important body advancing reforms for the global financial market. It has produced policies, standards of supervision and regulation for the financial sector.

Successive financial crises were making the need for reforms ever more evident. The majority of these reports point to the need for reforming the Bretton Woods institutions, but also for formal mechanisms to negotiate international debt, regulate international capital flows, and stabilize the persistent currency volatility among major industrial countries. The great crisis represented new challenges such as systemic risk and "too big to fail" banks, banks' subsidiary regulation, regulation of financial innovation and credit rating agencies, and even reforms of regulatory institutions.

Meanwhile, the focus of the Financial Stability Board (2015) on the international financial architecture is different, especially in terms of the financial sector in developing economies, with financial problems like portfolio flow volatility, foreign currency over-indebtedness, higher interest rates for financing in local currency, and high risk ratings, among others.

Building global financial governance is under way in legislation (Dodd-Frank Act 2010) led by financial consortia to stabilize financial markets and continue global expansion. An important element of this process is the participating governments' adoption of common legal frameworks or resolution processes in the case of the bankruptcy of financial institutions. These procedures allow for the legalization of bailouts wherever the subsidiaries of the global financial institutions are located. Also, they allow for the separation of profitable segments from the larger entity upon bankruptcy.

Thus, the reconstruction of the international financial architecture, more like financial governance driven by the market, has not affected the main structural characteristics of the double monetary circuit and the dollarization trends in Latin American countries. This double monetary circuit, along with liberalization and deregulation, mean an ongoing need of US dollars for lenders of last resort. This role has been played either by the US Federal Reserve or the IMF, with conditions placed over macro policies and financial system regulation.

This feature of the financial system has developed to such an extent that the IMF continues a programme of assessment of financial systems (IMF 2001). This programme includes a range of actions to promote financial deepening and to harmonize regulatory frameworks. It states that

> the areas of improvement have included reforming financial law (law of the central bank and banking supervision), conducted in line with international best practices, [to] strengthen risk management in the insurance sector, modernize payment systems to collect and monitor indicators of financial sector vulnerability, intervene and resolve problems of troubled financial institutions.
>
> (IMF 2001: 19)

However, neither the double supervision (domestic and IMF) nor the regulations concerning capitalization, good practice, fraud control, money laundering, risk management, modernization of systems, etc. have been able to contain the effects of dollarization on the balances of the banking sector or regional economies as a whole.

Quantifications and comparable information on the level of dollarization of LA economies are hard to come by and difficult to elaborate on one's own. However, for example, in Chile, 22 per cent of total banking assets are in foreign currency; in Peru, the dollarization ratio of liquidity is 27 per cent; and for Latin America as a whole, the World Bank gives 27 per cent. However, these figures leave out many off-balance-sheet operations as well as important segments of the economy that are dollarized.

As has been seen with the large-scale development of global banks, institutional investors and securitization in local markets, dollarization is also a strong force of economic structural change. The dollarization of profits encouraged not only growing public and private indebtedness, but also privatizations, mergers and acquisitions. Domestic firms and investors as well as foreign banks and firms do measure profitability in foreign currency. It is not pure desire, but pure economic rationality.

Moreover, as the subsidiaries of foreign banks have shown in Argentina, Brazil and Mexico, they have no special interest in expanding and deepening domestic markets. They wish to take advantage of a position that guarantees a return above that achieved in their countries of origin. They cannot face the currency mismatching against their profits or dividends at the expense of shareholders. Losses due to exchange rate adjustment can be passed on to insurance deposits or any other mechanism of government support or to depositors' savings.

To the extent that income from commodities exports started to fall in 2014, it is inevitable that the dynamics of dollarization will thrust upon regional economies new episodes of financial fragility and the devaluation of local currencies. Even with foreign banks having more than 30 per cent of the market, and stalling the most acute consequences of this fragility, governments are left in a position with less to do. This is due to the fact that these banks respond to the business strategies of their parent banks and public credit is restricted by austerity policies.

With the dollarization of profits, the features outlined by Minsky concerning Latin American financial systems as entities "financing transit-goods" now have new meanings.

Note

1 This chapter is a result of the DGAPA–UNAM research project Competencia Financiera Global y Regional: Modelos de Financiamiento Post-Crisis. The authors are grateful to Jesús Sosa for his support and to Fernanda Vidal for his Spanish to English translation of the chapter.

References

América Economía (2015). "Ránking 250 mayores bancos de América Latina". Available at: http://rankings.americaeconomia.com/mejores-bancos-2014/ranking-250-mayores bancos-de-america-latina/ (accessed 7 November 2015).

Cepal (2000). *Crisis Bancarias: Causas, Costos, Duración, Efectos y Opciones de Política*. Santiago de Chile: United Nations. Available at: www.cepal.org/es/publicaciones/7512-crisis-bancarias-causas-costos-duracion-efectos-y-opciones-de-politica (accessed 8 November 2015).

Cepal (2016). Cepalstat Database. United Nations Economic Commission for Latin America and the Caribbean. Available at: http://estadisticas.cepal.org/cepalstat/WEB_CEPALSTAT/Portada.asp (accessed 9 January 2016).

Claessens, S., Köse, A., Laeven, L. and Valencia, F. (Eds) (2014). *Financial Crises: Causes, Consequences, and Policy Responses*. Washington, DC: IMF.

Correa, E. (1992). *Los Mercados Financieros y la Crisis en América Latina*. México; IIEc–UNAM.

Correa, E. (2013). "Modelo de negocios financieros y reforma regulatoria en la crisis financiera global", in G. Vidal, A. Guillén and J. Déniz (Eds), *América Latina: ¿Cómo Construir el Desarrollo hoy?* Madrid: Fondo de Cultura Económica, pp. 133–156.

Correa, E. (2015). "Budgetary impact of social security privatization: Women doubly unprotected", *International Journal of Political Economy*, 44(4): 260–276.

Correa, E., Déniz, J. and Palazuelos, A. (2009). *América Latina y Desarrollo Económico*. Madrid: Akal.

Demirgüç-Kunt, A. and Detragiache, E. (1998). "Financial liberalization and financial fragility", IMF Working Paper WP/98/83.

Dodd-Frank Act (2010). Dodd-Frank Wall Street Reform and Consumer Protection Act. Available at: www.sec.gov/about/laws/wallstreetreform-cpa.pdf (accessed 6 September 2015).

Eichengreen, B. (1999). *Towards a New International Financial Architecture: A Practical Post-Asia agenda*. Washington, DC; Peterson Institute Press.

Ferreiro, J. and Rodríguez, C. (2004). "Sistema financiero Español y su expansión hacia América Latina", in E. Correa and A. Girón (Eds), *Economía Financiera Contemporánea*. Mexico City: Miguel Ángel Porrúa, pp. 211–233.

Ffrench-Davis, R. (Ed.) (2001). *Crisis Financieras en Países "Exitosos"*. Santiago de Chile: Cepal and McGraw Hill.

Ffrench-Davis, R. and Ocampo, A. (2001). "Globalización de la volatilidad financiera: Desafíos para las economías emergentes", in R. Ffrench-Davis (Ed.), *Crisis Financieras en Países "Exitosos"*. Santiago de Chile: Cepal and McGraw Hill, pp. 1–44.

Financial Stability Board (2015). *Second FSB Annual Report*. Available at: www.fsb.org/wp-content/uploads/FSB-2nd-Annual-report.pdf (accessed 2 February 2016).

Girón, A. (1995). *Fin de Siglo y Deuda Externa: Historia sin Fin*. [*The End of the Century and External Debt: A Story without End*.] México: Cambio XXI and IIEc–UNAM.

Girón, A., Correa, A. and Chapoy, A. (2005). *Consecuencias Financieras de la Globalización*. Mexico City: Miguel Ángel Porrúa.

Goldstein, M., Hills, C. and Peterson, P. (1999). *Report of an Independent Task Force Sponsored by the Council on Foreign Relations*. Washington, DC: Institute for International Economics.

Group of 22 (1998). *Summary of the Reports on the International Financial Architecture*. IMF: Washington, DC. Available at: www.imf.org/external/np/g22/ (accessed 8 August 2015).

IAASTD (International Assessment of Agricultural Knowledge, Science and Technology for Development) (2009). *Agriculture at the Crossroads. Vol III, Latin America and the Caribbean*. Washington, DC: Island Press. Available at: www.unep.org/dewa/agassessment/reports/subglobal/Agriculture_at_a_Crossroads_Volume_III_Latin_America_and_the_Caribbean_Subglobal_Report.pdf (accessed 6 November 2015).

IMF (2001). *Report of the Managing Director to the International Monetary and Financial Committee: The Fund's Crisis Prevention Initiatives*. Washington, DC: IMF. Available at: www.imf.org/external/np/omd/2001/111401.htm (accessed 10 December 2015).

IMF (2010). "Dollarization declines in Latin America", *Finance and Development*, 47(1): 57. Available at : www.imf.org/external/pubs/ft/fandd/2010/03/dataspot.htm (accessed 8 February 2016).

International Federation of Pension Funds Administrators (2014). *Executive Statistical Report*. Santiago de Chile: FIAP. Available at: www.fiapinternacional.org/wp-content/uploads/2016/01/informe_ejecutivo_estadistico_no_35__datos_a_dic__2014_-1.pdf (accessed 3 January 2016).

Kregel, J. (1998a). "Yes, 'it' did happen again", The Levy Economics Institute of Bard College Working Paper No. 234, April, Annandale-on-Hudson, New York.

Kregel, J. (1998b). "East Asia is not Mexico", The Levy Economics Institute of Bard College Working Paper No. 235, May, Annandale-on-Hudson, New York.

Kregel, J. (2000). "The Brazilian crisis", The Levy Economics Institute of Bard College Working Paper No. 294, February, Annandale-on-Hudson, New York.

Lichtensztejn, S. (1984). "Una aproximación metodológica al estudio del capital financiero en América Latina", *Revista Economía Teoría y Práctica*, 2, México, Universidad Autónoma Metropolitana. Also published by *Ola Financiera*, January–April 2009: 137–186.

Lindgren, C.-J., Garcia, G. G. and Saal, M. I. (1996). *Bank Soundness and Macroeconomic Policy*. Washington, DC: IMF. Available at: www.imf.org/external/pubs/cat/longres.aspx?sk=1538 (accessed 18 November 2015).

McKinnon, R. (1973). *Money & Capital in Economic Development*. Washington, DC: Brookings Institution.

Mathieson, D. and Roldós, J. (2001). "The role of foreign banks in emerging markets", paper presented at the World Bank, IMF and Brookings Institution 3rd Annual Financial Markets and Development Conference, 19–21 April, New York. Available at: www1.worldbank.org/finance/assets/images/Role_of_Foreign_Banks_in_Emerging_Markets__body.pdf (accessed 12 October 2015).

Meltzer, A. (2000). *International Financial Institutions Reform: Report of the International Financial Institutions Advisory Commission, March 2000*. Available at: www.eldis.org/go/home&id=28196&type=Document#.VyGgRsrQVFU (accessed 5 February 2016).

Minsky, H. (1991 [1977]). "La banca central y el comportamiento de una economía", in L. Bendesky (Ed.), *El papel de la banca central en la actualidad*. Mexico City: CEMLA México, pp. 174–198.

Parguez, A. (2010). "El doble circuito monetario depredador: Los costos de la plena integración al sistema financiero y productivo multinacional", *Ola Financiera*, 6, May–August: 1–33.

Rojas-Suárez, L. and Weisbrod, S. (1997). "Las crisis bancarias en América Latina: Experiencias y temas", in R. Hausmann and L. Rojas-Suárez (Eds), *Las Crisis Bancarias en América Latina*. Tlalpan, Mexico: Fondo de Cultura Económica, pp. 1–24.

Sánchez-Albavera, F. and Lardé, J. (2006). *Minería y Competitividad Internacional de América Latina*. Serie Recursos Naturales e Infraestructura, No. 109. Santiago de Chile: Cepal.

Shaw, E. (1973). *Financial Deepening in Economic Development*. New York: Oxford University Press.UNCTAD (2001). *Trade and Development Report*. New York and Geneva: United Nations. Available at : http://unctad.org/en/Docs/tdr2001_en.pdf (accessed 8 February 2016).

UNCTAD (2015). *Trade and Development Report*. New York and Geneva: United Nations. Available at http://unctad.org/en/PublicationsLibrary/tdr2015_en.pdf (accessed 8 February 2016).

United Nations (2009). *Report of the Commission of Experts of the President of the United Nations General Assembly on Reform of the International Monetary and Financial System*. Available at: www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf (accessed 4 February 2016).

Vidal, G. and Marshall, W. (2013). "Financial flows and Mexico, the dollarization he e market, and for LA the WB gives 27%bank, Goldman Sachs isis and reached a al markets atracted ncial 's disintegrated spaces of production", in L. P. Rochon and M. Seccareccia (Eds), *Monetary Economics of Production*. Northampton, MA: Edward Elgar Publishing, pp. 160–178.

Vilariño, A. (2001). "La presencia de los bancos españoles en la economía mexicana", *Información Comercial Española*, 795: 101–112.

World Bank (2002). *World Development Report*. Washington, DC: World Bank. Available at: https://openknowledge.worldbank.org/bitstream/handle/10986/5984/WDR%20 2002%20-%20English.pdf?sequence=1&isAllowed=y (accessed 5 August 2015).

World Bank (2015a). Global Financial Development Database. Washington, DC: World Bank. Available at: http://data.worldbank.org/data-catalog/global-financial-development (accessed 5 August 2015).

World Bank (2015b). *International Debt Statistics 2015*. Washington, DC: World Bank. Available at: http://data.worldbank.org/sites/default/files/ids2015.pdf (accessed 5 August 2015).

Zubizarreta, J. H., de la Fuente Lavín, M., De Vicente Arias, A. and Koldo Irurzun Ugalde, K. I. (Eds) (2013). *Empresas Transnacionales en América Latina. Análisis y Propuestas del Movimiento Social y Sindical*. Universidad del País Vasco. Available at: http://publicaciones.hegoa.ehu.es/assets/pdfs/294/Empresas_transncionales_en_America_Latina.pdf?1372929459 (accessed on 5 February 2016).

11 Financialization in Brazil

A paper tiger, with atomic teeth?

Pierre Salama

Introduction[1]

Can we consider that there is a happy financialization in Brazil? In a world where the rise of finance has been accompanied by increasing income inequalities, a reduction in job security, a strong disaffiliation and real wages stagnation, Brazil is a singular case. On the one hand, finance is developing, credit is rising, international reserves are climbing; and on the other hand, poverty is in decline, income inequality has fallen slightly, income is rising, the ratio of formal/informal employment is improving, unemployment is down and idle production capacity remains low. Is financialization a "paper tiger", as China once, in the 1960s, branded the United States? Or inversely, does this Brazilian singularity hide an underground disintegration process? Does it mask real threats to employment and income? Continuing the metaphor suggested by the debate between China and the Union of Soviet Socialist Republics (USSR) surrounding the United States, if financialization is a paper tiger, does it have atomic teeth – in other words, in the long term, does financialization result in grave consequences for the level of employment and income? To date, deindustrialization is approaching the point of no return in Brazil, imports have risen dramatically, especially for medium- and high-technology sectors. Brazil's external vulnerability is rising and its dependence on the export of raw materials is becoming ever more perilous; growth has slowed down and already the rise in income has become modest. Is the rise of financialization the principal reason for Brazil's deindustrialization and new forms of vulnerability? What are then the main roots of the process of financialization and the boom in raw material exports throughout the 2000s?

After defining what is meant by financialization and deindustrialization, and highlighting the particularity of the Brazilian path, this chapter seeks to explain why income and employment rose in Brazil while in other countries they were in decline. We analyse the limits of this model and show how the "paper tiger" that is financialization can prove to be dangerous for employment and income.