# The Pattern of Change in Latin American Banking: An Overall View *

That part of the world, extending from the Rio Grande to the Magellan Straits and referred to, geographically, as Central and South America and culturally, as Latin America, is striking for the community of her problems and aspirations as well as for the variety of her underlying characteristics. While the Iberic civilization impressed an indelible mark on the Continent, some fringe areas retain the imprint of other cultures. The Latin influence fell on pre-existing ethnical and social structures, different in the degree of their advancement toward organization, arts and techniques. The result was that in some parts indigenous and extraneous elements merged in forming new nations, in other parts they came to coexist as separate entities; and in still others immigrants from the outside prevailed upon native peoples. Thus, in panorama, one may note striking differences from country to country, with some of them presenting a uniform social structure along European lines, others showing sharp contrasts between most primitive and most advanced patterns of society.

To these differences in ethnical and social characteristics correspond differences in physical resources and the ways people meet the struggle for daily life. The great variety of agricultural products and cattle, raised in tropical and temperate climates and on high plateaus and lowlands, and of minerals from the underground and resources from the surrounding seas witness to the opportunities of the future. The contrast between a well developed coastal strip, circling the entire continent, and the untapped wealth of its heartland is witness to the fact that the exploitation of resources was for

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long related to foreign initiative and reflects the vicissitudes of a daily life dependent on foreign needs and demand.

The political upheaval, which in the past century brought to Latin American countries their independence, coincided with newly emerging attitudes toward freedom and nationalism. In this century, their path toward economic and social progress is characterized by efforts to accelerate beyond any normal rate of growth the development of a country's own resources and of its basic and industrial processes. All Latin American countries have at last entered the era of industrialization. Several among them have reached a level at which they can no longer be considered underdeveloped. In the latter nations, primitive practices of subsistence living co-exist with the technological processes of the most advanced enterprises.

In this environment of political and economic change, the central banks of Latin America have outgrown their formative phase, reflecting in their development the pervasive effects of internal and external influence. Their contribution to the changing pattern of the economies has been reflected in the promotion of new ways and instruments of financing, the support of new types of financial institutions in public and private fields, and the assumption of intermediary roles between the government and the financial community at home, and between these and the foreign and international institutions. In the course of their history, these central banks have not limited themselves to adapting to their own needs the practices and instruments that had been evolved by their counterparts in Europe and the United States; they have also forged ahead with new tools for shaping policies in unprecedented situations, striving toward the objective of monetary stability under continuing pressure of rapid economic and social changes.

## The Impact of Change on the Financial Structure

Economic development and social changes, through their impact on incomes and consumption and the redistribution of wealth, have pervasive effects on processes of savings formation and on financial systems. There are, in the first place, shifts in market relations whenever improved transportation facilities lead to the opening of new sources of supply; these bring about a contraction in hand-to-hand transactions and an increase in the use



of money. In the second place, a more widely monetized economy and increasing time-lags between production and distribution result in new needs for credit transactions that did not exist before. In the third place, the growth of trade and the formation of modern industries call for concentration of funds in amounts larger than any family or close groups could provide, as in the past; this leads to the need for new instruments suitable for attracting the savings of those classes of the population — skilled workers and managerial and bureaucratic officials — whose potential to save is rising rapidly in line with their rising incomes.

The pressure to expand resources, and the enticement of new lending opportunities, induces banking institutions to spread their activities out of the leading cities into smaller towns and rural areas. Also, the need for longer term financing and for specialized operations, growing to a point exceeding the facilities that commercial banks may offer, opens the way for new financial institutions and the beginning of an investment market. The processes by which the financial structure has evolved in the various countries of Latin America, side by side with the economic transformation, reflect differences in habits and forms of saving formation, the experience and practices of financial institutions, and the initiative of businessmen and bankers. An understanding of the processes of monetary policy and the functioning of instruments of credit control cannot be obtained out of the context of the existing financial system; while there are many similarities, there also exists a great number of differences.

In general, *commercial banking* is an established tradition in all countries of Latin America, and with few exceptions (such as the banking of Costa Rica and some individual banks in other countries) the commercial banks are privately owned. Within each country, commercial banks are usually well organized and operate on departmental bases, with savings, mortgage, trust and foreign operations department. They also maintain branches and offices outside the principal cities, which enable them to conduct operations at national, regional and local levels. In several countries, United States and European banks participate through their branches and subsidiaries in the financing of foreign trade and investments, and also of local business. Very few Latin American banks, on the other hand, maintain offices in other countries of the region and their correspondent relations are still limited, though they are

in process of making their contribution to closer relations between various countries.

Traditionally, the Latin American commercial banks concentrate on financing the current needs of business with loans for an initial term no longer than one year (generally coming under the heading of "commercial banking" operations). Although the portfolios of these banks include credits to all sectors of the economy, the greatest part are related to commerce, inventories and the working capital of diverse enterprises, among them particularly those engaged in industry, agriculture and mining. There is little evidence, on the other hand, of credit being extended for long term or investment purposes. In some cases this restraint may be attributed to the fact that demand for loans to cover current business requirements absorbs all their available funds, but in other cases it may be attributed to a rather conservative attitude of the banking community and a reluctance of its members to part with established customs. Nevertheless, the long-established practice of commercial banks to maintain lines of credit to their clients, once established, and to grant renewals on their loans makes it difficult to draw any clear demarcation as to credit use, on the basis of indicated purpose or maturity schedules.

It should also be noted that, as a general rule, the loans granted by banks are required to be destined for productive rather than for commercial purposes, and, under certain conditions, banks do, in fact, finance industry and agriculture at somewhat longer term. For example, in most countries, banks are authorized to grant loans for intermediate terms (beyond one year and up to, say, five years) for purchase of equipment and expansion and improvement of business and agricultural plants. The granting of such loans is frequently related to rediscount facilities made available for that purpose by the central banks, and to exemptions from reserve requirements. However, commercial banks have seldom shown independent initiative in these types of operations.

In many Latin American countries commercial banks have participated actively in *real estate financing*. The traditional interest of wealthy families in farm or urban properties, the promotion of better housing facilities in the past decade, and the habit of lending on mortgages, all have given stimulus to the introduction of specialized institutions and instruments in this field. By and large, commercial banks conduct their mortgage operations through spe-



cialized departments, in competition with other private institutions and government agencies expressly set up for the purpose.

One instrument that has gained great popularity — among borrowers, institutions and investors alike in Latin America — is the *mortgage certificate* (*cedula hipotecaria*). Although a non-banking instrument in its origin and legal nature, this certificate nevertheless has been brought within the system by the banks themselves; the practice is for the banks to advance funds to borrowers against mortgage certificates and to offer these, in turn, to their depositors as investments. Although the financial institutions do not, as a rule, endorse the certificate they handle, they frequently give informal and unwritten commitments to repurchase them on demand. In some countries, in fact, these certificates are not actually transferred, but sales or repurchases between institutions and customers are simply noted in passbooks, thus giving this instrument the appearance of a savings account. The popularity of the mortgage certificate as a savings instrument may be attributed to the property lien by which it is guaranteed, the special fiscal privileges it enjoys, the higher interest rate it carries, and the liquidity provided by the intermediary financial institutions. Last, but not least, its success arises from practices of central banks, which utilize it as an instrument in their monetary operations with commercial banks and other savings institutions.

Another important instrument for raising mortgage funds is the *mortgage bond* (*bono hipotecario*) issued by commercial banks, through their mortgage departments, and by specialized mortgage institutions, both public and private. These bonds finance the construction and purchase of not only residential, but also public buildings, particularly of local governmental entities. They frequently find their resting place in the portfolio of commercial banks (as investment for part of their reserves) and of the central bank itself. In addition, other private savings and loan institutions (such as "sociedades de ahorro y prestamos" and "sociedades de capitalization") have recourse to various means for promoting their mortgage activities. These include tie-in savings and loan contracts, which offer a customer a commitment for a loan whenever his savings account reaches a certain amount, and savings accounts combined with lottery and insurance incentives to attract new savings and, in some cases, to circumvent interest rate limitations. Finally, in a growing number of countries low-cost housing is

recognized as a social function requiring the contribution of public funds by means of budgetary allocations and the investment of reserves of social security systems, as well as loan funds obtained from international institutions and foreign governments. In various countries these initiatives have been connected with the promotion of new cooperative-type institutions (along the lines of savings and loan associations common in the United States or the Reffeisen cooperatives of German origin), in order both to foster the habit of systematic savings and to provide a basis for self-financing of homes.

This combination of commercial banks and specialized institutions, making use of widely-accepted instruments, has contributed to the formation in most countries of adequate facilites for real estate financing, such as do not exist for other activities. In Latin America, *agricultural financing* is a special problem, because the technical level of farming and cattle raising may vary, within the same country, from the most primitive Indian culture to modern plantation-type enterprises, and differ even more, in size of enterprises and type of operations, between country and country. In general, commercial banks finance the movement of commodities and cattle through middlemen as part of their regular operations. In practically all countries, they are also pressed by their governments to participate — by assignment of credit quotas and allocation of reserve funds — in providing working capital and improvement loans jointly with official banks and agencies, especially established for the purpose of providing easier and cheaper credit to agriculture.

Some countries, such as Mexico, have a complete system of lending institutions (or banks) each specializing in some specific aspects of farming, cattle raising and fisheries. These various operations are concentrated in one or a few special banks in other countries (such as Bolivia and Colombia), or handled elsewhere (Ecuador, Venezuela and Brazil) through regional banks coordinated by a central institution. In a few countries (as in Argentina and Chile) there are national and local public banks which combine special agricultural financing with ordinary commercial banking operations. Usually, specialized institutions deal exclusively with agriculture or some aspect of it (such as land reform), but in some others this financing is part of general development functions. It is common practice for these institutions to be supported by the



allocation of funds from the government and aided by the central bank, through regulations and special credits.

An experiment in this field, which has been spreading in recent years, is the "supervised credit" including, in addition to the financing of rural activities, technical assistance, training processes, and local appraisal of the productive value and risk of the loans granted. This system, initiated by the Costarican banks through special departments within their own organization and rural committees set up at the local level, has met with sufficient success to warrant its adoption, in one form or the other, by banks in other countries. Also in this field, the warehousing of agricultural surpluses and support programs for certain agricultural products have been financed by official agencies or commercial banks through the allocation of public funds or under special regulations. During the 'fifties, these operations were frequently a factor in the inordinate expansion of credit by central banks, thus aggravating then existing inflationary pressures.

In the field of *industrial financing*, the practice of most countries since the war has been to assign this task to official organs. They are referred to in some cases as development corporations (such as in Venezuela), development banks (Brazil), finance companies (Mexico), or industrial banks (Argentina and Peru), or just plain banks (Chile). Their performance has been, at best, irregular, and with few exceptions they have failed to confirm the high hopes placed in them. Their deficiencies, failing to provide enough credit or providing too much of it, may be attributed to one or a number of several factors:

(a) Most of these institutions seem to have suffered from inadequacy of resources; although the original capital might have been regarded as adequate, it was usually provided in the form of government credits and its mobilization was possible only through the central bank, thereby setting in motion or adding to the inflationary spiral;

(b) Whatever the amount of the capital, it became rapidly inadequate as new financing activities were added by the government, requiring the allocation of resources to purposes unrelated to the original scope of the institution;

(c) Most of these institutions suffered also from a scarcity of manpower, particularly in those areas requiring operating and technical skills rather than administrative academic preparation;

(d) Political pressures in the selection of loan risks and the application of special interest rates prevented the institutions from establishing their own credit standing, prestige, and independence in domestic and in foreign markets;

(e) All in all, the establishment of such institutions in the past was often regarded by government and management as an easier alternative than a genuine effort to promote private and public initiatives, relying on "market" resources and striving to create a "market" environment and an investors' consciousness with respect to industrial development.

Not all official organs for industrial financing or development have, of course, been subject to these handicaps, or in a uniform way. A few, like the "Nacional Financiera" in Mexico, have proved successful in attracting funds from the general public in competition with private institutions in the domestic market, and in establishing their credit with the private lenders in foreign markets; these have complemented the resources available from foreign and international institutions. Most of the special organs set up in various countries for developmental purposes have been reorganized in recent years, to include private participation and to separate the programming from the financing functions. Their reorganization was in most cases related to stabilization programs, which cut off the recourse of these institutions to funds from the central bank and obliged them to seek a greater flow of longer-term funds from other internal or external sources.

Side by side with the formation of official institutions has been the emergence in certain countries, since the end of the war, of *private institutions specializing in industrial financing*. Apart from credits by commercial banks for current requirements and inventory needs and, to some extent, fixed equipment, the industrial field in most Latin American countries has failed to attract private savings and venture capital in any amount commensurate with the rate of development under way or with competing fields, such as construction and real estate. It may be said that so far only in a few countries has private initiative succeeded in bringing into existence types of institutions and instruments appropriate for longer term and industrial financing and in integrating them with the commercial banking system. In other countries such institutions have grown parallel to, but outside of the banking system; in some cases and at times, they have been accepted as members of the financial community, while in others barely tolerated, or opposed, as undermining the existing banking order. In still other instances, new institutions have been the manifestation of pioneering efforts by individual leaders, without broader effect in the financial community.



The most important example of the first case is Mexico, where private finance companies have taken their place in the financial system. Finance companies and banks are linked through joint, horizontal or vertical ownership, constituting about twelve private financial groups, half of which account for the greater part of the financial resources of the country. Each group includes, in addition to a leading commercial bank, a number of other banks, and trust, finance, and mortgage companies. There is complementarity of operations and mobility of funds within each group, providing strength and liquidity at the same time. Trust companies, for instance, are primarily collectors of funds, while finance companies are the largest borrowers, and the commercial banks the principal intermediaries.

Finance companies in Mexico raise funds by the issuance of short term acceptances (in national and foreign currencies) and through the placement of finance bonds. The latter have gained wide popularity among savers, overcoming the mortgage certificate itself; the companies use the proceeds for the purposes of financing existing industries and other businesses, promoting new ventures, and acquiring control of individual enterprises or even entire branches of economic activity. The finance companies take advantage of their link with commercial banks, their departmental and branch organization, contacts with clientele, and operating experience, to pursue their ends with aggressiveness, not entirely devoid, of course, of risks in taking up and supporting new ventures. The growth of finance companies has been favored by a positive attitude on the part of the authorities, which recognized from the beginning their potential contribution to development and directed their interest to longer term and investment operations, while bringing them gradually under their regulatory power.

The development of similar companies in other countries has followed different patterns. In Colombia, since the late 'fifties, banks have taken the initiative in setting up industrial finance companies in combination with other domestic financial institutions (insurance companies) and with foreign interests from Europe, the United States and Latin American countries. To date, these companies

have raised their funds mainly by equity and direct borrowing, and have provided financing by extending loans, without excluding participation in industrial companies, especially in new ventures. In Argentina, the development of finance companies in the last few years has taken place, with some notable exceptions, outside of the banking system. It has reflected the pressure for credit from commercial and industrial enterprises, in part to meet their needs for working capital and inventories, but more generally to support the distribution of their products. Companies specializing in consumer finance, and the industrial companies themselves, have raised funds by circulating short term paper, at interest rates considerably above the maximum rates permissible for commercial banks; this has frequently diverted resources from productive investments. This growth of institutions and instruments, not subject to the strict limitations imposed upon banks, has been of concern to the authorities, which have been elaborating normative rules designed to restrain their expansion and to direct their activities to intermediate and longer-term productive financing.

All in all, the Latin American countries are provided with distinctive institutions and instruments characteristic of money markets and appropriate for financing the movement of goods and real estate. A foundation also is being laid down for specialized institutions, both private and public, designed to finance agriculture and industry. More uneven is the record of the various countries with respect to the formation of *capital markets*, in which investment requirements of business can be met by the placement of bonds and shares in the portfolios of specialized institutions and with individual savers directly. The European tradition, and the more advanced stage that had been reached by banking institutions, favored the growth of stock markets in such countries as Argentina, Uruguay and Brazil prior to the war, until the combination of inflation and controls stemmed their further development and actually set them back after the war. Stock markets are fairly well developed in some other countries, such as Colombia, Peru, and Venezuela. In Mexico the rapid growth of the finance companies has tended to institutionalize the flow of funds to industries by loan rather than equity financing; the liquidity provided by such companies for their securities has tended to merge short and long term saving instruments and to blur any demarcation between money and capital markets. Efforts have been made in Central America



to develop a capital market on a regional basis, but there as elsewhere they are confronted with resistance by family or closed groups objecting to any spread in ownership and to opening their business to outside participation. These efforts have been obstructed also by lack of information and the distrust of savers for corporate bonds and stocks, by the absence of intermediaries providing effective marketability and reliable quotations for market securities, and, frequently, by legal provisions favoring traditional instruments (mortgage certificates) and discouraging the introduction of new securities. Experimentation with mutual funds in certain countries (such as Mexico, Colombia, Venezuela and Argentina) has met so far with slow-to-moderate acceptance.

The extent to which Latin American peoples have developed *banking habits*, using demand deposits as means of payments and holding liquid balances in accounts with banks and other financial institutions, varies greatly from country to country. Some comparative indication of shifts in banking habits and the relative development of new facilities may be obtained from the changes that have occurred over the years in the ratio between the outstanding currency in circulation and the levels of demand deposits of the public, and in the distribution of current liabilities between banking and other financial institutions. Between 1946 and 1960, while currency in circulation expanded sharply in all countries, bank deposits and other institutional accounts tended in the aggregate to advance still faster, reflecting both the effects of inflationary policies, and the greater needs for money to support rising levels of production and incomes. Also, both currency and demand deposits (the classical money supply) generally lagged behind other accounts (quasi-money), reflecting the increased popularity of the latter in response to the assurances of liquidity and the more favorable conditions offered in their respect by the various financial institutions, including the banks themselves. In 1946, currency in circulation was exceeded by demand deposits in ten countries (Argentina, Brazil, Colombia, Costa Rica, Cuba, Chile, Honduras, Peru, Dominican Republic, Uruguay) and by aggregate current liabilities of the financial system in two others (Ecuador, Mexico). In the following years, the expansion of deposits and other accounts overtook currency expansion in most countries, and by 1950, the level of currency fell below that of demand deposits in twelve countries and below overall liabilities in thirteen. There was a setback in the

ratio of demand deposits to currency in the following decade, as the number of countries in which such deposits exceeded currency declined again to ten by 1955 and to nine by 1960 (Brazil, Colombia, Costa Rica, Chile, El Salvador, Mexico, Peru, Uruguay, Venezuela). On the other hand, the aggregate current liabilities of the financial system rose above currency in fifteen and sixteen countries, respectively (that is all, except for Bolivia and Paraguay).

A few examples may round out this picture. The expansion of currency overtook deposits in Argentina between 1946 and 1955, when the concentration of banking liabilities in the central bank minimized the incentive of commercial banks to attract funds and accounts from the general public; and also in Bolivia and Paraguay, where rampant inflation and inadequacy of banking facilities enhanced the public's reference for currency in lieu of bank accounts. In Mexico, on the other hand, aggregate liabilities leaped forward over both currency and demand deposits, in line with the more rapid growth of finance companies as compared with commercial banks, and of the use of accounts as compared with that of currency. All in all, it may be said that the post-war era has witnessed a relative expansion of banking habits and a rise of competitive institutions in most countries, despite the monetary and economic disturbances that beset them at one time or another.

## The Place and Role of Central Banks

Born in the aftermath of the First World War, the central banks of Latin America may look back to their formative years in the 'twenties as a period of stability and confidence that has never returned. The depression of the 'thirties, the Second World War in the 'forties, the developmental strains in the following decade, and the last stabilizing efforts have represented an uninterrupted sequence of trying experiences. The central banks have held to their objectives of a balance between internal and external factors, and the pursuit of monetary stability and sustained economic growth. In many countries, the central banks have been intermittently confronted with political pressures, from autocratic governments disregarding any rule of law, or from parliaments making their own laws according to the circumstances of the moment or as a means for escaping their own responsibilities. Operating through great upheavals and against great odds, they have been able nevertheless to strengthen their internal organization, to gain a position of influence in the banking community at home and of respect among foreign banks and international institutions, and to attain a participating role in the formulation of the economic policies of their own governments. It is not surprising that the history of central banking in Latin America has been one of trials, errors and successes, internal reorganizations of their structures, shifts and adaptation of their instruments, and reappraisals of their functions in the light of changing national and international attitudes.



From the beginning, legislators and technicians, who cooperated in drafting the laws that set up the central banks of Latin America, recognized the need for a legal, administrative and institutional framework that would complement and support monetary policy. Plans for organizing central banks in the twenties, for instance, embodied provisions for the reform of the currency standard, the enactment of banking legislation, the establishment of a banking superintendence, the introduction of administrative procedures and controls over fiscal operations, and the organization of mortgage institutions broadening and diversifying the financial structure. Similarly, and in recognition of the interdependence between a central bank's operations and the interests of the various sectors, its ownership and administration were distributed among the government, the banks and the public, with provisions intended to prevent any one group from gaining overriding control. In successive reorganizations the mixed (or private) ownership was gradually replaced by full government ownership, but participation of the various sectors of economic activity in the administrative and policy organs was maintained and strengthened.

Another aspect of significance in the early organization of central banks was the concern about the adequacy of banking facilities. Most of the early central banks were authorized to conduct operations with the general public directly (i.e., not through financial institutions) and a number retained, together with a monetary or issue department, other departments for general banking and specialized operations. The purpose of these direct operations with the public was threefold: namely, to set standards for banking operations in general, to supplement banks in areas or operations where their facilities were inadequate, and to extend their own facilities to private fields of recognized public interest. With the expansion of commercial banking facilities and the adop-

tion of more appropriate credit policies, the central banks have been withdrawing gradually from dealing directly with the public, except where a national interest is involved. Most departmental central banks have since been reorganized, by the separation of their monetary or issue departments as new central banks, and the other departments continuing to conduct independently commercial and other banking business.

From an opposite point of view, the earlier legislation contained provisions restricting any lending by the central banks to their treasuries, and in some cases prohibiting such lending altogether. The more severe the limitation, the less applicable it proved in practice, being honored in some countries more by exceptions than by compliance. Thus, central banks were frequently required, by executive orders or special legislation, to grant temporary drafts to the treasuries which, as they could not be repaid, remained as permanent advances, to which others were added from time to time. This situation, and the difficulty encoutered by the treasuries in obtaining alternative sources of funds, finally led to recent legislative changes allowing them to obtain swing credits from the central banks, in accordance with seasonal budgetary patterns.

The shift in the ownership of central banks and the regularization of their lending to the governments reflect the universal recognition that central banks are public organs autonomous within, but not independent of, the governments by which they are created. In all countries of Latin America nowadays the executive power participates in the formulation of monetary policy: it is empowered to appoint the high officials of the central bank, it is represented on the boards charged with formulating policies, and it retains the right to veto, approve or concur in key decisions. Concurrently, the central banks have moved toward their governments, and most of them are now represented on national economic councils. However more than any written rule, are the informal ways by which they have gained the right to be " heard " by their governments. The process of exchange of information, views and consultation between the central banks and the ministries of finance or economic affairs has gained ground consistently at the policy and staff levels, and has become in some countries a regular and ordinary procedure. In some respects, this exchange has been facilitated by the reserved powers of the government to approve or to veto the central bank's decisions, which has induced a practice of advanced consultation



and stimulated informal contacts. In recent years, the position of the central banks has been further strengthened by the role they have played in formulating and implementing stabilization programs.

By and large, the central banks in Latin America have the advantage of an economic intelligence staff, that concentrates selectively on, for example, national income and balance of payments, which have become increasingly important in modern techniques of analysis and policy decisions. This advantage has also opened for the central banks a role in international negotiations, in which their estimates and informed opinion are sought with respect to problems under discussion. Similarly, their close connection with the government and their information and analysis of economic conditions at home and abroad strengthen their relations with the private banking community, which in its operating and policy decisions, has come to rely on public statements from and informal contacts with central bank officials.

These trends, manifest all over the world and more so in Latin America, are leading central banks to a new role of intermediaries between their own government and the financial community, between their own government and foreign and international financial institutions, and between the banks and other financial interests in their respective countries and banking and financial interests abroad. In domestic policies, the central bank is expected to provide the government with an understanding of the operations and problems of the private banking community, at the same time explaining to the community the underlying reasons for any measure affecting it. In international financial negotiations, the task of the central bank is to present, in the most effective way, the proposals and point of view of its own country to the foreign or international organs, while stressing to its own government the powers and limitations under which such organs operate. Also in virtue of its own foreign operations and contacts with foreign banks, the central bank may be called upon to advise on the adoption of procedures and the undertaking of transactions of significant importance of the nation. The central bank, by its responsible participation in government functions, its operations within the domestic financial system, its relations with foreign central banks, and its international functions best represents, in effect, the open door of the country to the rest of the world.

## The Development of Monetary Instruments

The changes in the organization and position of the Latin American central banks have been reflected in the adaptation of their policy instruments from the original to new uses. By and large major, or almost exclusive reliance has been placed on general instruments of monetary policy — namely, rediscounts, operations in securities, and reserve requirements. From the beginning, however, the central banks have adapted these instruments to selective ends, in line with their changing objectives over time.

*Rediscount*, the classical instrument of central banking, was inherited as such from the practices of European commercial and central banks. From the beginning, all central banks of Latin America have made use of it in flexible ways respect to its traditional aspects, namely the maneuverability of the rate and the eligibility of the paper. The multiple rate system has been the prevailing practice, applied with the object of favoring, with lower rates, productive transactions and discouraging, with higher rates, commercial and other transactions not considered essentially productive. Until recently, control over the rediscount rate had been applied so as to hold down, or decrease, the cost of money to ultimate borrowers; in recent years the emphasis on stabilization has spread the use of higher rates, above those applicable in the market, as penalties for banks incurring deficits in their reserve requirements.

The eligibility of the paper for rediscount has also been adapted in accordance with special criteria. Originally, the type of paper was specified in order to encourage banks to move away from personal lending towards loans related to effective underlying transactions, and to improve bank portfolios by inclusion of marketable paper, as distinguished from direct non-marketable loans. These " sound banking " purposes were later on combined by the central banks with preferred treatment for agricultural and industrial paper, especially of longer maturities, so as to divert credit from commercial to productive activities and to diversify the portfolios of banks. From the beginning, commercial banks were granted ceilings (usually related to their capital accounts) under which they could rediscount eligible paper; in the course of time, these ceilings became in effect credit floors, above which were added special lines for those particular types of loans that the central bank intended to favor. These practices, however, were ended in later years, in line



with the adoption of stabilization policies. This combination of rates, paper and ceilings has been applied, at one time or another, by most central banks, and perhaps most consistently in Colombia and Chile.

Provisions for *securities transactions*, have been written in the banking legislation of most countries, along the lines of Federal Reserve open-market experience. They have found limited application, however, due to policies of artificially low interest rates more than to the absence of securities markets — itself a consequence, in part at least, of the interest rate policy. In varying degree, all central banks have conducted operations in securities on an over-the-counter basis, either directly or through the use of special funds; most of them, however, found themselves saddled in the past with securities issued at unmarketable conditions by government and development and other special agencies. It is this experience that induced the framers of stabilization programs to block direct purchases of securities by the central banks as a measure to curb the spiral of inflation.

Experience indicates that, where appropriate rates and terms were set, central banks could operate in two-way transactions of purchases and sales — but where this principle was disregarded, they could only absorb securities and create credit by automatic process. The example of the Banco Central de la Republica Argentina between the latter 'thirties and the early 'forties was most notable in that it made two significant innovations: it created a new instrument of market operations by the issuance of its own certificates (certificado de participacion), representing participation in its holdings of government bonds; and, by creating a market for such certificates it opened the way for a Treasury bill market as well. The first innovation demonstrated that a central bank did not need to be hampered in its monetary management by the absence of appropriate government securities, since it could always create its own paper (or convert claims against the government into such paper), at terms and conditions suitable for investment by the market. The second innovation demonstrated that, where a market for government securities did not exist, or was unreceptive to investments in such securities, the central bank could promote it by offering obligations in its own name, tailored to the type and form that could later be offered by the Treasury itself. The lesson of the Argentinian experience, that a market can be created by a willing-

ness to meet its conditions, finds further confirmation in the adaptation by the Latin American central banks of the mortgage certificate as a monetary instrument. The interest rates, repurchase agreements, and fiscal exemptions applied to such certificates made them attractive to investors and enabled many central banks to purchase or sell them in adjusting the liquidity position of financial institutions and of their markets in general.

The instrument most generally used to offset any credit expansion resulting from rediscount and purchases of securities by the central banks has been the *reserve requirement*. Introduced for the first time in Mexico in 1936, shortly after its application in the United States, it has since been adapted by the Banco de Mexico as the key instrument of its credit policy — both for quantitative and for qualitative purposes. The basic principle of this technique is the application of the maximum reserve requirement (one hundred per cent on deposit increases from a certain date), and the waiving of such requirement for any stipulated proportion of assets held in specified types of productive loans and investments. The system is based on the orthodox concept of a fixed minimum percentage to be held as reserve in cash or deposit at the central bank; moreover a built-in flexibility is maintained by allowing a quota for free disposition by financial institutions, by making available to them rediscount facilities, and by providing for automatic purchases and sales of securities to adjust the level of reserves. The central bank also refrains from interfering with the loan process between bank and customer or with the determination of individual interest rates and other conditions in their operations. The system is clearly designed to achieve two results: in the short run, to assure a minimal provision of credit to sectors previously without, or with limited access to the banking system, and in the longer run to spur the initiative of the banks and the banking habits of peoples in establishing bank-to-customer contacts, upon which a more permanent relationship might be built.

The effectiveness of the system in Mexico induced its application in Colombia (where it was at first superimposed upon a complicated rediscount system and then substituted by direct control over the composition of bank portfolios) and in certain other Latin American countries. Another interesting innovation in reserve requirements, by the central banks of Colombia and Ecuador, has been their seasonal use in lieu of rediscounts, by lowering the ratios



gradually in periods of seasonal needs and raising them again as the needs subside. Moreover, in all countries of the continent the application of special or marginal reserves, and their compulsory investment in government or special bonds, have had the purpose of facilitating government and development financing, while allowing the banks some earnings on their reserves. More fundamentally, the maintenance of special reserve requirements and their tight enforcement to restrict credit expansion have been a common feature in all stabilization arrangements since the late 'forties.

Traditionally, *direct credit control* in Latin America has been related to regulations applied by the central banks or other authorities as part of their banking supervisory functions or exchange control systems, rather than to further and support their monetary policies. As for the latter, however, a recent innovation is the limits set to the rate of expansion of financial institutions or credit instruments. Originally adopted with little success in Chile, in a phase of rampant inflation, it has been more effectively used in Mexico as a means for regulating the relative growth of different sectors of the financial market. There, for instance, the offering of short term paper by finance companies is restricted, with the object of inducing them instead to place long term obligations consistent with comparable lending opportunities; similarly mortgage institutions have been limited in the amount of mortgage certificates they can place, in order to prevent any unduly large diversion of funds from other productive uses. Provisions for this type of control — which corresponds in a way to the British experience in requiring banks to cut back loans by specified percentages — have been written in new legislation for central banks in Central America. In substance, the block imposed, in certain stabilization programs, on the operations of special lending institutions, or the borrowing by the government or special sectors of the economy may also be regarded as a variation of this technique.

Because of the diversity of operational and regulatory procedures applied by the central banks of Latin America, a simple reading of their balance sheets provides no clear or systematic indication of their monetary policies: they show only direct operations or those which result in a change of their assets and liabilities. Their balance sheet may well indicate the extent to which rediscounts, holdings of securities, and foreign exchange assets have operated as factors of monetary expansion and contraction. The figures of deposits

held in the central bank by other banks may reflect changes in their primary reserve requirements, and the trend of currency in circulation may provide an indication of the expansion of the money supply and, hence, a prima facie evidence of the relative success or failure of the central bank in controlling it. The central banks' statements, however, do not reveal how nor to what extent reserve requirements might have been used for qualitative purposes, nor do they reveal the application of limits of expansion to market institutions and instruments.

With these qualifications, an examination of the balance sheets of the Latin American central banks, between 1946 and 1960, indicates that the distribution of assets and liabilities has been subject to wide variations, from central bank to central bank, and from year to year in any one institution. For instance, currency in circulation represents between 40 and 60 per cent of the liabilities of most central banks, but in some may be as low as 20 or 30 per cent (as in Brasil, Ecuador, Mexico and Nicaragua) or as high as 70 or even 90 per cent (as in the Banco Central de la Republica Dominicana and the monetary departments of the central banks of Bolivia and Uruguay), dependent upon the diversification and overall level of operations of each institution. In a more direct way, the balance sheet of the Banco Central de la Republica Argentina between 1946 and 1957 reflected the special arrangement then prevailing, under which the deposits of commercial banks, and their credits as well, were registered on the books of the central bank; the balance sheet for the years since 1957 reflects in turn the release of funds from this arrangement. In other cases, such as for the central banks of Chile and Peru, their balance sheets between 1955 and 1960 show increases in the deposits of banks and decreases in advances to banks, in line with the application of stabilization measures. There are offsetting shifts between gold and foreign exchange reserves, on the one hand, and between advances and rediscounts, on the other hand, in the figures of various central banks (Costa Rica, El Salvador, Guatemala, Mexico, Dominican Republic and Venezuela between 1955 and 1960), reflecting fluctuations in the flow of their international and domestic payments.

The figures for "other accounts" (both liabilities and assets) disclosed the comparative importance of services and special operations performed by central banks, such as carrying the accounts of international institutions, administering government and special trust funds, guaranteeing foreign borrowing by their governments or banks, and holding securities and other assets in custody for governments, banks, and others. In certain central banking institutions (such as those of Argentina and Honduras until 1955, and Cuba, Peru, Dominican Republic and Uruguay) these accounts appear to be comparatively small (that is, 20 per cent or less of their total), while they seem especially large (50 per cent or more) in the case of a few others (such as those of Brasil, Ecuador, Mexico and Nicaragua, as well as Honduras and Argentina in 1960); in all other central banks they range somewhat in between these limits.



In their comparatively short history, from the early 'twenties to the early 'sixties, the central banks of Latin America have perfected their internal organization, strengthened their position with the government and in the market, and sharpened the instruments at their disposal for dealing with problems confronting them. In analyzing such instruments, one should beware of identities in terminology that may not reflect similarities in substance. The adaptation of the rediscount to selective uses by Latin American central banks appears similar to the practices of certain central banks of Continental Europe in differential rates, examination of underlying transactions, and establishment of credit lines. However, their procedure of case by case examination of each individual request for rediscount by a bank in accordance with general criteria set forth in advance, bears a resemblance to that of the Federal Reserve Banks though not to that of the Bank of England, the lender of last resort which extends its facilities to brokers with no apparent concern as to which bank had been or would be the ultimate borrower. With respect to securities transactions, the Latin American central banks seem to resemble more closely those of Continental Europe than the Federal Reserve or the Bank of England, in their practice of operating directly with issuers and financial institutions, rather than with dealers and brokers in anonymous ways. In reserve requirements, the closest analogy may be found between the secondary reserves established by the central banks of Latin America and the special account set up by the Commonwealth Bank of Australia at the beginning of the war; one may also find analogies with the secondary reserves and liquidity coefficients applied by European central banks, including the Bank of England, but hardly any with the more restricted concept

applied by the Federal Reserve System. Among the Latin American central banks themselves, any generalization requires qualification, since each instrument has been adapted to the financial conditions and structure prevailing in each country.

## The Framework of Monetary Policy: Development and Stability

Much of what has been written about problems and objectives of monetary policy in the past, and about the interplay of monetary and fiscal policies in recent years, seems to assume that the impulse of these actions is transmitted, through the medium of the financial system, to the underlying sectors of the economy. This assumption, however valid as it might be for countries with organized and settled money and capital markets, does not equally apply to countries whose markets, when they exist, are imperfect; nor in instances where the resiliency of an emerging market may induce reactions on its part tending to offset the actions of monetary and fiscal policies. In all cases, however, monetary policy cannot be made or judged in isolation from the general framework of economic policies and the financial system in which central banks and treasuries operate.

The contribution of general measures of monetary and credit policy in smoothing out cyclical swings and sustaining business activity and employment at home has been the traditional preoccupation of Federal Reserve authorities in the United States, at least until recently, when concern about the balance of payments equilibrium has caused a reconsideration of aims and means of policy. Such a combination of internal and external forces, impinging upon the economy of a country, has been the everlasting problem of European central banks, particularly the Bank of England; these banks have resorted to both general and direct measures, in order to make flexible and prompt adjustments in their domestic economies and in the international flow of funds. For the central banks of Latin America, the pursuit of internal monetary stability has been complicated by recurrent balance of payments swings — of too much or too little — combined with pressures from accelerated development spanning over such swings, inadequacy of the fiscal systems, and financial structures that, in general, failed to keep up with rising and diversifying credit needs.



The formative years of central banks in Latin America, during the 'twenties, were generally characterized by the establishment and maintenance of stability and convertibility for their currencies and the strengthening of their banking systems to meet current needs of trade and production of their economies. The depression of the 'thirties confronted the central banks with the problem of how to maintain external price stability, cover growing deficits in national budgets, meet wide fluctuations in the movement of short term funds, manipulate depreciating exchange rates, and apply complicated systems of controls, for internal and external purposes. These difficulties were suddenly reversed during the war, when their major concern became the neutralization of the inflationary effects of balance of payments' surpluses and the inflow of foreign funds. It was hoped that the accumulation of exchange surpluses could provide the resources for a development effort, as soon as the foreign sources of supply would reopen.

As the war came to an end, however, competing demands within the foreign countries and in Latin America contributed to rising prices generally undercutting rapidly the value of such resources. Development efforts became increasingly entangled with inflationary expansion, in which the central banks became, in many countries, the passive agents of overriding forces. The revival of monetary policy under way in Europe and the United States since the early 'fifties, has found a wide response in Latin America since the mid-fifties, and the stabilization programs adopted by various countries at one time or another are a reflection of this new worldwide trend.

In the current debate between "monetarists" and "structuralists" in Latin America one may hear the echoes of the universal controversy as to the choice between contrasting objectives of monetary policy and the ways and means by which the central banks may strive to attain them. Central bankers have been confronted with these problems ever since the guiding rules provided by the gold standard were replaced by discretionary processes of monetary management. The debate in Latin America centers at present on the apparent conflict between monetary stability and economic development. It was precipitated by the failure of development programs to accelerate the rate of economic growth by non-inflationary means, and by the public's reaction to the adoption of stabilization programs designed to restore an economic balance by

monetary and fiscal measures. In part, this debate — like any other — has aspects of semantics, such as in the use of terms "policy", "program", "development", "stabilization". The term "program", implies a forced rescheduling of economic and financial factors in such way as to alter the structure and working of the economy; the term "policy" carries a connotation of a progressive influence exerted to guide the economy in a gradual way. Recourse to a development program is taken, by and large, as a sign of dissatisfaction with the effectiveness of general policies pursued in the past, while the adoption of a stabilization program is interpreted as a sign of confidence in such policies. One expert sees merits in a dynamic course, while another may believe that strength lies in stability.

The sharp rejection of development without stability, and the immediate and critical preoccupation to bring the inflationary spiral to an end, caused stabilization to be introduced in many countries without any correlated programs or policies for development. Two points of view seem to have prevailed, in Latin American countries, as well as among international institutions cooperating with them; namely, an implicit assumption that stability would by itself generate new forces of development or, on the other hand, the assertion that the resumption of development, whether on a programmed or a free basis, should await the attainment of stabiity. This "wait and see" attitude left a vacuum in the economic policy of certain countries, which, combined with political pressures, endangered both stabilization and development.

The experience indicates that while a stabilization program is necessary to stabilize — and the sharper and the quicker the better — a development program should also be on hand to promote rapid growth as soon as conditions permit. This implies recognition of coordinated and mutual support between development and stability. The contribution, that monetary authorities may make in development councils, is by their informed opinion as to the quantitative limits within which investment targets can be set, consistent with internal and external stability; thereafter, acting on their own, they may adapt their policies in ways that would contract overall demand or divert financing, or both, in accordance with the development goals. A stabilization program may well end, but a stabilization policy is a never-ending effort, as long as the nation is engaged in developing and diversifying at an accelerated rate.



One of the most critical aspects of development and investment programs in the past was the major emphasis placed on allocation of resources and financing, with little or no concern toward raising and channelling the necessary funds in non-inflationary ways. The creation of development or industrial banks by governments seldom met this problem, since these banks relied for their funds on special sources — from abroad, the budget and the central bank. They subsequently lent or invested such funds on non-marketable bases. In effect, the development of modern enterprises in the productive field was not accompanied by a parallel development in the financial structure; also, there was a reluctance to recognize that financial costs, as determined by the market, should be counted as components of business costs. The balance of the demand for and supply of funds is dependent, in any modern economy, on a complex of institutions and instruments; their functions consist in offering to savers alternative choices, according to liquidity preference and yield expectations, and in meeting the diverse financing requirements of modern business in accordance with their productive and investment opportunities.

## The Changing Scope of the Financial System

A financial system should serve a broader scope in any economy than merely financing projects. The introduction of diverse institutions, acting as intermediaries in the collection and placement of funds at home is essential to lessen the propensity on the part of wealthy individuals to entrust their funds to institutions abroad; a variety of accounts help to divert medium and small savings of the general public from cash holdings into institutional channels. An efficient financial system involves always the introduction of new institutions and instruments, competing in forms and conditions with those already in existence and offering yields high enough to compensate for any loss of liquidity. This is a task that can only be effected gradually, by a continuing adaptation of existing practices in accordance with changes in the needs of borrowers and the attitude of savers.

It matters little, in principle, whether the formation of a financial structure is the product of governmental, business or banking initiative: in practice, commercial banks have more than any other institutions, the strength, prestige and experience to develop

specialized operations in their own organization or through affiliated and related institutions. Several avenues are open to them. They may set up separate departments with specialized functions (for example for trust and investment business); or they may organize subsidiaries, in which a bank or a group of banks may hold the entire capital; they may participate in joint ventures with their own government or other domestic or foreign investors. What matters to the continuing growth and diversification of these departments or institutions is their reliance on the credit and the name they may establish in the "market", at home and abroad, rather than on any support from the government or assistance from the central bank — except, of course, for such facilities that are extended to them in the normal course of fiscal and monetary operations.

In any modern financial system, the central bank is the reservoir of liquidity for institutions and the market as a whole, but is in turn subject to the limitations of its own and its country's liquidity in terms of international reserves. As a rule, the market (that is, financial institutions, business and individuals) holds liquid assets (in the form of bank deposits or other short term claims) in some proportional relation to current needs (in terms of current payments, working capital and financial transactions): these cannot be drawn down normally without a corresponding contraction of business. Whenever excess liquidity is activated in the form of credits and investments, the role of the central bank consists in taking offsetting monetary actions in order to restrain the effects on internal and external stability. A problem arises whenever intermediate and long term financial assets, created to finance investments and held in the market over and above current liquidity needs, are made convertible on demand into bank deposits or other monetary assets by rule, contract, or practice. This places the central bank on call by financial institutions, whenever their own liquidity is jeopardized by such conversion. Such situation, which has prevailed in certain Latin American markets, may confront the central bank with a difficult and dubious choice. That is, its unrestricted monetization of financial assets would impair confidence in the currency and in its own international liquidity, but its refusal to honor an implied commitment would impair confidence in the financial institutions and their instruments and precipitate a crisis of solvency, as well as of internal liquidity. This dilemma may represent a real and imminent danger where no clear distinction is made in the practices



of institutions and in the mind of the public between monetary and financial assets. Such distinction may well be a matter of degree, but differences in degree are important for maintaining the delicate balance between the extent to which holders of financial assets might exercise their option of shift into monetary assets, and the margin of safety of the central bank in acquiescing to such demand.

The formation of a financial market, including facilities for shorter and longer term operations in savings and investments, is more than the establishment of institutions and the introduction of instruments: it is the acceptance of practices separating what is short and liquid from what is long and fixed, not only on the books of institutions, but above all in the mind of investors; and the recognition of the need to restrain, by the interplay of yields and prices, the convertibility of financial into monetary assets. The promotion of new institutions and practices, along market lines and in support of their own policies and national objectives, is not new to the Latin American central banks. They may claim to their credit the introduction of new banking practices, the estabishment of a mortgage market, the beginnings of securities transactions, and the redirection of bank credit and diffusion of banking facilities.

In their own ways, central banks of Latin America have anticipated some of the innovations adopted by central banks in other parts of the world: for instance, in the participating certificate of the Banco Central de la Republica Argentina one may see the forerunner of the creation and issuance of special instruments, by the central banks of Belgium, Denmark and Germany, for open market operations to support management of their public debt and monetary policies. The use of reserve requirements for seasonal purposes by the central banks of Colombia and Ecuador has found application by the Reserve Bank of New Zealand and by the Bank of France (with respect to its liquidity coefficients). The setting of a definite limit to the expansion of a type of credit, so effectively applied by Mexico, has been found of value by the Federal Reserve for restraining foreign financing by banking and non-banking financial institutions. And finally, another policy pursued by the Banco de Mexico, aimed at synchronizing and projecting into longer terms the maturities of liabilities and assets of finance companies, has a counterpart in measures taken, for instance, by the Bank of Italy with respect to intermediate term financial institutions. Some experiences

in Latin America also have counterparts in those of other central banks in different parts of the world, old and new, which have operated to promote new instruments and practices (such as the bankers' acceptance, Treasury bills, foreign banking operations, and Federal funds' market in the United States), to broaden the market for government securities (by the introduction, for example, of Treasury bills in Belgium and Italy), and to create new financial systems (including development institutions and a market for securities, in Australia).

The contribution that central banks can make to market formation is paramount in developing countries. They may attract private savings, dispersed in the economy or held abroad, into domestic financial institutions; they may open to industries and other enterprises access to such savings, at appropriate terms, market rates and competitive conditions; and they may provide mobility of funds by diversifying credit instruments and savings opportunities. This task of market formation is not an isolated process; it complements the other responsibilities incumbent upon the central banks, which, jointly, are designed to support the development of their economies in a framework of internal and external stability.

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