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Making Capital Markets Work for the Brazilian People

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- A. The magnificent payoff from well-functioning capital markets (banks, mutual funds, insurance companies, stock markets):**
- **First result: Much more productive use of national savings; hence faster growth with a given savings ratio, or the same growth with a much lower savings ratio. Compare Chile with Peru (about 20% savings, GDP growth about 5% vs. 2%); or US with Europe (4% vs. 2% growth, though US has less savings).**
 - **Second result: Higher ratio of wealth to income (ratio of three or four vs. one or two) and faster growth of wealth (up to 8% in real terms vs. under 4%).**
- B. Four cornerstones of a well-functioning capital markets: Honesty, Prudence, Efficiency, and Innovation. The trick is to balance the cornerstones, because they sometimes pull in different directions.**
- C. HONESTY.**
- **Simple schemes: Ponzi schemes, fraudulent statement of assets; corporate reporting of fictitious revenue (e.g., anticipated sales) or wrongful capitalization of expenses (WorldCom type schemes).**
 - **Complex schemes: connected lending (widespread in Asia); indefinite rollover of principal and interest; no mark-to-market in evaluating loan portfolios and hence capital adequacy; inadequate and delayed disclosure by corporations (abetting insider trading).**
 - **Antidote: strong, independent, well-paid regulatory bodies. Rocket science is not required. This is a cops-and-robbers task of exposing rotten practices. To be effective, the regulatory scope should coincide with the geographic and market scope of the financial institution.**
- D. PRUDENCE.**
- **First temptation: inadequate diversification by financial firms. Attempt to score big by concentrated lending or investing. Upside goes to shareholders and officers; downside goes to depositors and policyholders.**
 - **Second temptation: excessive leverage, as a way of boosting the return on equity. When things are going well and interest rates are low, why not try to run on a capital ratio (equity to assets) of 5% or less (the LTCM example)? Why not believe in historical VAR models (Argentine banks)? But then the unexpected happens.**

- **Third temptation: mismatched liabilities and assets, in terms of currency or maturity. This is a huge risk for developing countries: remember Thailand.**
- **Fourth temptation: “gambling for redemption” when things go sour. Equity is nearly wiped out; regulators are about to seize control; therefore double or triple the bets.**
- **First antidote: strong, independent, well-paid, and *very smart* regulatory bodies. To ensure prudence, *rocket science is required*. The regulators have to be as smart, and nearly as well paid, as those they regulate.**
- **Second antidote: financial institutions that have a broad geographic and market scope, so that diversification comes naturally to the business.**
- **Third antidote: periodic sophisticated reports, by the regulators, to the public and to the legislature, alerting them to prudential dangers.**

E. EFFICIENCY.

- **What we are talking about is lower spreads on bank interest charges vs. bank payments to depositors; lower interest rates on credit cards; faster mortgage applications with lower fees; smaller management fees for mutual funds; smaller charges on buying and selling shares.**
- **The difference between bad and good capital markets is a multiple of two or three in these various charges. High expenses deprive household savers of their rewards and discourage the accumulation of wealth.**
- **Opening the market to competition from foreign financial firms – the object of the Doha Round and the FTAA – can spur efficiency. The purpose of foreign competition is *not* to drive local financial firms out of business. That would put depositors and policyholders at risk, as well as shareholders.**
- **The combination of greater efficiency and financial stability can best be ensured through buyout requirements. As the domestic market is opened to foreign firms, the foreign firms should be required to acquire domestic firms, or form joint ventures with them.**
- **However, the objective of efficiency sometimes collides with the objective of diversification (as a method of promoting prudence). In particular, diversified financial institutions may “tie” their products, e.g., lending and floating shares.**

F. INNOVATION.

- **Innovation is critical to drive efficiency and spread risk. As a financial system matures, share markets should grow relative to banking (for example, in the US, mutual funds are now bigger than bank lending). Insurance premiums should grow relative to GDP. Mortgages should be packaged and sold as securities.**
- **Yet sophisticated innovations can be a breeding ground for complex dishonesty. Share markets are often rife with fraud and sharp practices (insider trading, etc.), and the risks inherent in derivative markets are sadly underestimated.**
- **Brazil should welcome innovation – both by domestic and foreign financial institutions. At the same time, its regulators should consult closely with regulators in New York, London, Frankfurt and the BIS**