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Inter-American Dialogue

Financial Services Advisor

Featured Q&A *with our Board of Advisors*

Q **US Treasury Secretary Henry Paulson earlier this month announced a three-pronged initiative to expand bank lending to small businesses in Latin America. What impact will the initiative have on lending to small businesses in the region? What effect could it have on Latin America's economies in general?**

A **Guest Comment: Eduardo Levy Yeyati:** "The initiative is certainly welcome, but its potential should not be overstated. This is not the first attempt to adapt prudential requirements to the needs of small and medium enterprises (SMEs), and the fact that SME lending is still an issue suggests that the problem goes beyond paperwork and relates, for example, to the high degree of informality prevalent among small businesses, and to the cost and uncertainty in effectively seizing the collateral, rather than to traditional rationing or lack of collateral. Besides, as recent studies indicate, at least in Latin America SME lending is constrained less by banks' unwillingness to lend than by a lack of loanable projects, a reflection not only of a deficit in the capacity of small firms to formulate projects, but also of a lack of demand on their side, as they find internal capital a cheaper (and more flexible) source of finance than bank funds. Moreover, it is not clear why the development of scoring models or the streamlining of bureaucratic procedures cannot be undertaken directly by the current players (the banks, in the first case; the local supervisor, in the second). In this light, the most promising element of the proposal is possibly the second one, which entails a subsidy component that may be justified based on the externalities of small firms (*e.g.*, regarding labor intensity and job creation) and the market imperfections associated with fixed costs and asymmetric information (particularly in the case of new firms without a credit track record). Here again, one wonders what is the comparative advantage of the Treasury *vis a vis* a specialized national development bank or agency."

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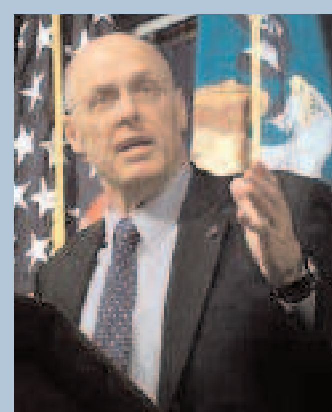
FEATURED PHOTO



US Treasury Secretary Henry Paulsen

Photo: US Treasury Department

Inside This Issue

FINANCIAL SECTOR BRIEFS

Head of Latin America for HSBC Appointed to Top Asia Post

HSBC said June 20 its president and group managing director for Latin America and the Caribbean, Sandy Flockhart, has been appointed chief executive of the British bank's Asian unit. Flockhart, who has held the Latin America post since October, will start in his new job next month, HSBC said. Flockhart's replacement in Latin America will be announced "in due course," HSBC spokesman Patrick McGuinness said, Bloomberg News reported.

US, Caricom Leaders Agree to Expand Financial Services

The US and 14 Caribbean Community (Caricom) countries pledged June 20 to expand the Caribbean's financial services sector. In a declaration issued after a meeting in Washington, DC, US President George W. Bush and Caricom leaders said they would seek to "encourage a focus on the international financial services sector to facilitate a competitive means of economic diversification while remaining committed to the maintenance of appropriate regulatory and supervisory practices, consistent with the highest international standards."

Venezuelan Development Bank Opens Office in Nicaragua

Nicaraguan President Daniel Ortega on June 21 inaugurated the new office of Venezuela's Bandes development bank in Nicaragua. The Bandes branch will start operations in Nicaragua with $20 million in capital, half of which is destined to seven local cooperatives in the form of low-interest loans.

Banking News

Oil Revenues, Liquidity Fuel Surge in Lending in Venezuela

Venezuelan bank lending jumped 84 percent in May compared to the same month a year earlier to 76.9 trillion bolivars ($US 36 billion), Venezuelan consulting firm **Softline Consultores** reported on June 15. One of the biggest jumps was at Venezuela's biggest lender, **Banesco**, which saw its loan portfolio rise 93 percent to 10.8 trillion bolivars, while number-two lender **Banco de Venezuela**, a unit of Spain's **BSCH**, experienced an 83.7 percent jump in outstanding loans to 10.0 trillion bolivars. Lending in Venezuela has surged amid increased liquidity, as the country—the world's sixth-largest oil exporter—continues to benefit from high global oil prices. Foreign exchange controls trap much of the increased liquidity in the country, prompting banks to lend more and helping drive the fastest inflation rate in the Western Hemisphere, according to Bloomberg News. Consumer prices rose 19.5 percent in May from a year earlier, above the Central Bank's target this year for 12 percent inflation. In addition, Venezuelan President Hugo Chavez has threatened to nationalize private banks if they fail to increase lending to industrial companies. The government requires banks to lend at least 31.5 percent of their portfolios to the agriculture, housing, and tourism industries, and small credits, according to Bloomberg News. Softline said total deposits in Venezuela stood at 136.3 trillion bolivars in May, up 64.68 percent from a year ago.

Venezuelan President Hugo Chavez has threatened to nationalize private banks if they fail to increase lending to industrial companies.

Experian Buying Control of Brazil's Serasa for $1.2 Billion

British credit information firm **Experian** announced June 26 it was buying control of Brazilian credit bureau **Serasa** for 2.32 billion reais ($US 1.2 billion) from Brazilian banks. Experian said in a statement it bought 65 percent of Serasa, the world's fourth-largest credit bureau and the largest outside the United States, from **Bradesco**, **Itau**, **Uniao de Bancos Brasileiro**s, and the Brazilian units of **ABN Amro Holding NV**, **Banco Santander**, and **HSBC**, and plans to increase its stake to 70 percent over the next six months, Bloomberg News reported. Experian Chief Executive Donald Robert said in a statement that the deal, which gives the company control of three of the top five credit bureaus worldwide, was a "transformational opportunity for Experian" and would give it a leading position in Brazil. Experian's CEO for the Americas, Christopher Callero, told reporters in Brazil that the South American nation would be "a launch pad for a lot of opportunities in the entire Latin American market," according to Bloomberg News. Serasa has a database with credit information on 161 million Brazilians and last year had sales of 607 million reais. The transaction is expected to be completed by the end of this month.

COMPANY FACTS

Serasa

* Founded in 1968
* Currently world's fourth-largest credit bureau
* Has credit information on 161 mn Brazilians.
* Sales of 607 mn reais in 2006
* Sales forecasted to grow 20% in 2007

Source: Experian

Ecuadorean Prosecutor Threatens to Charge Citibank Executive

Ecuador may press charges against a **Citibank** executive if he doesn't turn over the names of bondholders to help an investigation into allegations of bond market manipulation by the country's economy minister, the Associated Press reported on June 21. Ecuadorean Prosecutor Jorge German said he may charge Citibank's representative in Ecuador, Bernardo Chancin, with obstruction of justice. Citibank has previously said that it will cooperate in Ecuador's probe. German has also sought help from the US Securities and Exchange Commission, via a letter to Linda Jewell, the US ambassador in Ecuador, to obtain information about holders of the 2030 bonds, the SEC said in a statement. The Ecuadorean prosecutor is investigating Economy Minister Ricardo Patino's role in a secret video that showed him talking with investors about spooking the market ahead of an interest payment deadline for the country's 2030 global bonds in February. Patino denies any wrongdoing, saying he rejected the proposal to shock the market and that it was his idea to record the meeting. Correa has stood by Patino, calling him an "honest man." In related news, Correa on June 19 accused former executives of **Produbanco**, the country's fourth-largest bank, of making bond policy decisions benefiting the bank while they held official positions in the economy ministry, Reuters reported. Correa said the bankers promoted an oil fund earmarked to pay debt, which pushed up bond prices. The president accused Mauricio Pozo, a former vice president of Produbanco who was economy minister in 2003, and other bank employees who were also ministry officials. Pozo denied the accusations, which he said were a politically motivated attack on the opposition. Ecuador is seeking to identify the holders of the debt negotiated by previous governments, amounting to about $3.86 billion, that Correa calls "illegal," according to Reuters.

Bancolombia CEO Sees Interest Rate Hikes Cutting Loan Growth in Half

Twelve interest rate increases made since last year by Colombia's central bank will cut loan growth in half in 2007 at **Bancolombia**, the country's largest bank, Chief Executive Officer Jorge Londono said June 21, according to Bloomberg

Research Alert

Latin America's Financial Systems on the Verge of a Breakthrough

Latin America's financial systems could be on the verge of a breakthrough if policymakers can continue to reduce public debt and reform their countries' financial and legal systems, according to a recent study published in *The McKinsey Quarterly*.

In terms of "financial depth," or the value of financial assets as a percentage of GDP, Latin America ranks as a region among the lowest in the developing world, at 133 percent in 2005, according to the study. That compares to 230 percent in China, 228 percent in emerging Asia, and 72 percent in India in the same year.

While Latin America's financial depth is up from just 40 percent in 1990, "its depth has not grown faster than that of countries in emerging Asia, so the region is not catching up," according to the study.

Citing a recent *McKinsey Quarterly* survey, the study noted that just 40 percent of business executives from Latin America said that their companies have good access to external financing, compared with 60 percent of executives from other emerging markets.

"Twice as many Latin American executives—31 percent—as executives from other countries report that insufficient funding for new investments will constrain the growth of their companies in the next three years."

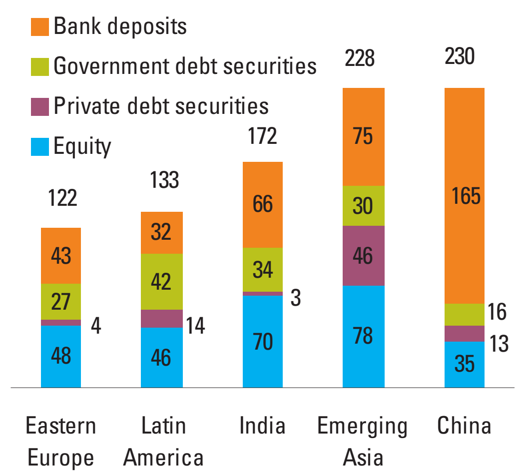
However, the study noted since 2002 the region's stock of financial assets has grown by 20 percent annually, up from just 5 percent between 1995 to 2002, amid greater macroeconomic stability.

To sustain the momentum, the study said, policy makers must build on macroeconomic reforms of past years by continuing to reduce public debt and increasing the independence of central banks in the region, the study said.

In addition, countries should pursue stock market reform and work to improve their pension systems and corporate bond markets to help reduce the cost of issuing equities and bonds on domestic markets, according to the study.

Financial Depth: Latin America vs. Other Emerging Markets

Financial assets as % of GDP, 2005



Source: The McKinsey Quarterly

Policy makers should also strengthen legal protections for creditors and expedite bankruptcy proceedings. Such steps would not only help remove barriers to the development of the region's financial systems, but help attract more savings, the study said.

News. This year, Londono expects Bancolombia's loan growth to fall to between 18-20 percent after growing 36 percent last year. Londono did not say how interest rate increases will impact Bancolombia's profits. In an effort to bring inflation down from a three-year high, the central bank has raised its benchmark interest rate by three percentage points since April of last year to 9 percent. After the fastest expansion in nearly 30 years during 2006, Colombia's economy grew 8 percent in the first quarter of 2007. Lending grew by 35 percent in the same time period. Londono also said Bancolombia would to continue its expansion in Latin America. "In the medium run, Bancolombia's regional expansion must continue,'' Londono said. "We have been working on building an institution focused on growth but one that isn't an acquisition target." In May, Bancolombia purchased 89 percent of El Salvador's **Banagricola** for $791 million. The acquisition was Bancolombia's first international purchase.

Economic News

Calderon Submits Tax Reform Bill to Mexico's Congress

The administration of Mexican President Felipe Calderon on June 20 submitted its proposal to collect more taxes by closing corporate tax loopholes, bringing the underground economy into the system, and decreasing dependence on uncertain fiscal revenue from state-owned oil monopoly **Pemex**. "The treasury needs to reduce its dependence on petroleum," Finance Secretary Agustin Carstens said, according to the *Los Angeles Times*. "The difficult challenge is to expand the tax base." Carstens said the country needs to double its non-oil tax revenue, which currently stands at about 11 percent of GDP, in the next 20 years. "We have a system that allows tax evasion in most cases if you have good accountants or good lawyers," Calderon was quoted as saying at an event in the state of Tlaxcala. "In the fiscal system that we're proposing, and that the country needs, there must not be any privileges." A gradually introduced flat tax on

The Dialogue Continues

How Might the Politics of Interest Rates Affect Microfinance?

Q Some Latin American officials, including Venezuelan President Hugo Chavez and Ecuadorean President Rafael Correa, have recently suggested that banks lower lending rates. What's behind the push for low lending rates? How might the politics of interest rates affect the microfinance sector?

A Guest Comment: Jose Sojo: "One of the difficulties that underdeveloped economies face is that when they seek financing in international markets they end up paying interest rates substantially higher than those paid by developed countries. Such rates become an obstacle to development, and often countries with low-income levels do not have access to financing to develop projects with a high social impact. The main objective of the private finance system is to maximize economic benefit. That is why development banks that contribute to achieving goals with social and other dimensions linked to integral national development are necessary. Microfinance programs have become an instrument of social inclusion, putting capital in the hands of those who have enormous development potential but do not have financial resources nor access to credit. There is no doubt that microfinancial institutions have allowed the incorporation of those excluded from the financial system. By lowering interest rates the cost of such projects fall and the probability of success of micro-business owners grows."

A Guest Comment: Beatrice Rangel: "As the experience of Chile, Costa Rica, Uruguay, and Colombia tells us, the shortest path to reducing the cost of capital is macroeconomic stability and incentives to save. Artificially low interest rates (*i.e.*, levels that do not reflect the price of scarce capital) lead to bad resource allocation, non-performing loans, and corruption. Thus, behind this push for low lending rates there can only be two factors at play. First and foremost is economic autism. Second are pressures on the financial system to accommodate itself to populism. Low interest rates benefit microfinance when they are a sign of capital availability. But when they are the product of government decrees, low interest rates are captured by firms and individuals that are perceived as low risk. These are those that already have access to capital. As credits are allotted to low-risk targets, capital fails to reach low-income sectors. This ends up strengthening skewed patterns of income distribution and perpetuating poverty."

"Artificially low interest rates ... lead to bad resource allocation, non-performing loans, and corruption."

— Beatrice Rangel

Jose Sojo *is Minister-Counselor for Economic and Trade Affairs at the Venezuelan Embassy to the United States.*

Beatrice Rangel *is Managing Director of AMLA Consulting LLC.*

Editor's note: the above is a continuation of a Q&A published in the June 12-25, 2007 issue of the Financial Services Advisor.

companies of up to 19 percent aims to bring more cash into the government's coffers while also closing some loopholes, according to the *LA Times*. That proposal may run into strong opposition from business groups that find they are able to take less tax deductions, Bloomberg News reported. The reform also proposes a 2 percent tax on cash bank deposits exceeding 20,000 pesos ($US 1,844) per month, a move aimed to collect taxes from small businesses that deal in cash in the underground economy. As expected, the government did not toy with the value-added tax, nor expand it to food and medicine, which would bring in billions of dollars but is widely seen as hurting the poor more than the rich. Such a tax is strongly opposed by the left-leaning opposition PRD party, according to the *LA Times*. [Editor's note: see Q&A on Calderon's tax reform proposal in the June 26, 2007 issue of the daily *Latin America Advisor*.]

Carstens said Mexico needs to double its non-oil tax revenue, which currently stands at about 11 percent of GDP, in the next 20 years.

Trade Talks Collapse in Germany; Parties Point Fingers at Each Other

Talks between four of the most powerful players in global trade collapsed on June 22, with representatives from the United States, European Union, Brazil, and India blaming each other for not putting enough on the negotiating table, the Associated Press reported. EU Trade Commissioner Peter Mandelson said the failure put the larger Doha Round of World Trade Organization talks at risk. "It was useless to continue the discussions based on the numbers that were on the table," Brazilian Foreign Minister Celso Amorim was quoted as saying after the meetings in Potsdam, Germany ended two days ahead of schedule. Brazil and India said the United States didn't offer enough cuts to US agricultural subsidies, while the US and European Union said that Brazil and India didn't offer new market opportunities for manufacturing exports. "Trade agreements should generate new trade and lift people out of poverty," US Trade Representative Susan Schwab was quoted as saying. "Unfortunately what we have here today was not going to generate new trade," she added. The failure "places a very major question mark over the ability of the wider membership of the WTO to complete this round," Mandelson said. [Editor's note: see related Q&A in the June 20, 2007 issue of the daily *Latin America Advisor*.]

Political News

Correa Changes His Mind, Says Assembly Should Dissolve Congress

Ecuadorean President Rafael Correa said June 23 he has changed his mind and wants Congress to be dissolved when an assembly created to rewrite the country's Constitution is convened later this year, the Associated Press reported. "Given the quality of this Congress ... if we are going to have an assembly it's going to have to dissolve Congress," Correa was quoted as saying during his weekly radio broadcast. "I believed that the Constituent Assembly did not have to dissolve Congress, that it could continue to supervise in parallel while the Assembly legislated but with this kind of Congress you can't do anything." Correa has criticized the Congress for failing to enact or watering down several of his legislative proposals, including an energy bill that sought to fight fuel smuggling, a practice that has cost the government $500 million per year, as well as legislation aimed at lowering interest rates charged by banks. Since taking office in January, Correa has pushed for the creation of the Constituent Assembly to reform the Andean nations' political system and curb the influence of traditional parties. Thousands, including supporters and opponents of Correa, have registered for election to the 130-member body in a September 30 vote. Correa has declared the Assembly election "the mother of all battles."

POLITICAL & ECONOMIC BRIEFS

Chavez: No Plans for More Nationalizations in Venezuela

Venezuelan President Hugo Chavez said he isn't planning more nationalizations, Spanish news agency EFE reported on June 21. Local and foreign private companies can "coexist with this revolution as long as they obey the law," Chavez was quoted as saying. The Venezuelan leader also said that "if the people say no," the country's Constitution won't be reformed as he has proposed.

Mauricio Macri Wins Buenos Aires Mayoral Election

Center-right opposition politician and millionaire soccer club owner Mauricio Macri won the June 24 mayoral election in Buenos Aires, Argentina. According to wire reports, Macri won 61 percent of the votes versus 39 percent for his opponent, Daniel Filmus. The outcome was seen as a blow to President Nestor Kirchner, who had picked Filmus to run for election to one of the country's most powerful political posts.

Zoellick Unanimously Approved as World Bank President

The World Bank's executive directors on Monday unanimously approved the United States' Robert Zoellick to succeed Paul Wolfowitz as the 11th president of the mulitlateral lender, the Bank announced in a press release on Monday. Wolfowitz was forced to resign in May amid charges of unethical behavior. Zoellick, a former US trade representative and US deputy secretary of state, and current executive at **Goldman Sachs**, begins his five-year term on July 1.

Featured Q&A
Continued from page 1

A Guest Comment: Tricia Juhn: "Treasury Secretary Paulsen's initiatives will shore up current market dynamics already in place, and they certainly won't hurt anything, but the programs in and of themselves are not of a scale to have a noticeable macroeconomic impact, and nor should they. Politically, the program is the result of a negotiated multilateral effort to promote entrepreneurship in Latin America, on the theory that over the medium and long term, anything that reduces poverty will also lessen outmigration to the US; and, not to be overlooked, that anything that creates prosperity abroad means bigger export markets for US consumer goods. At the micro-level, however, several benefits should arise. First, the program will support the creation of credit infrastructure to a tranche of the population that has thus far been denied credit—the fact of which has been a serious drag on growth. Second, with 80 percent of loans under $100,000 each, the program will create much-needed liquidity for a credit-starved tranche of small- and medium-scale enterprises (SMEs). Third, it's a multilateral effort (with the IDB), which is good PR these days. But most importantly, it sends a clear signal that the United States government supports the SME sector through the easing of access to credit and, necessarily, related financial services—which means that the days of exclusionary lending are over. Although this is primarily a market-driven phenomenon—driven by financial services firms looking for new customers—it has the happy advantage of providing a much-needed service to a portion of the population that has long been denied."

A Guest Comment: Maria Velez de Berliner: "According to Pyramid Research, Latin America has on average 13 small businesses to each large one. By Latin American standards these, small business enterprises (SBEs) thrive despite government corruption, bureaucratic red tape, onerous tax systems, and Byzantine regulatory systems. Any extension of credit to SBEs is needed and welcome. Every SBE deserves to grow and prosper. However, Latin America, not the US, needs to establish lending targets if this program is to help its economies grow, create employment, improve the skills pool, and alleviate poverty. The key is which sectors will stimulate growth and development in the long run. Development in the 21st century demands a large technical skills pool, high levels of education, access to technology, and capital to acquire it. Technical skills development, higher education accessible to the majority, and advanced technology introductions or acquisitions are a must if Latin America is to move from the commodities-for-export trap and be prepared to face China and India on a relatively level playing field. This is where US lending should go. Creditworthiness verification, loan collateral, and other requisites for granting loans are technicalities. Lending to the wrong sectors is not. Avoiding this requires an overall strategic objective. If the program is to help SBEs import US capital goods and skills not directly related to education, technical development, and growth, lending will benefit the US, not Latin America."

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