I. Banking systems: characteristics and structural changes

Serge Jeanneau[1]

This chapter provides an overview of banking systems in Latin America and the Caribbean (LAC), with a particular focus on those of smaller countries. The first section of the chapter looks at the main features of banking systems in the region. The second surveys the main structural changes in banking systems and analyses the implications of these changes for financial intermediation. A box on page 13 discusses recent trends in bank lending.

Main features of banking systems

Banks play an essential role in the allocation of economic resources. They are key players in the provision of capital and, hence, in stimulating economic development. In fact, bank credit and GDP per capita are highly correlated. Although the direction of causality is the subject of some debate, emerging market economies (EMEs) with large banking sectors tend to have a higher level of economic development than those with smaller banking sectors (IADB (2004)), and the LAC region is no exception to this relationship, as shown in Graph 1.1.

However, there is a great deal of heterogeneity across countries in terms of the depth of banking markets (see Table 1.1). This heterogeneity is not simply related to the economic size of a country or to its GDP per capita since some countries have larger banking sectors than would be implied by these features. As shown in Graph 1.1, this is particularly true for Caribbean countries with large offshore financial centres (OFCs). By contrast, some of the larger economies, such as Argentina and Mexico, have smaller banking systems than would be implied by their level of economic development (reflecting the lingering impact of severe financial crises over the past decade or so).

Aside from the features just discussed, banking systems in the region show a number of common characteristics.[2]

Limited depth and narrow focus of financial intermediation

In most countries of the developing world, financial intermediation is dominated by commercial banks for two main reasons. First, banks continue to have an advantage in the processing of information and the diversification of risk, which are central elements in financial intermediation (Singh et al (2005)). Second, many countries lack an adequate infrastructure for the development of securities markets as alternative sources of financing.

In LAC, although banks are dominant, banking sectors remain shallow. Outside of Chile, Panama and the Caribbean countries, credit to GDP ratios are well below 50% in several countries (see Graph 1.1 and Table 1.1). The average ratio of credit to GDP for the region is also lower than that of the industrialised world, and of some other regions of the developing world (see Table 1.1).

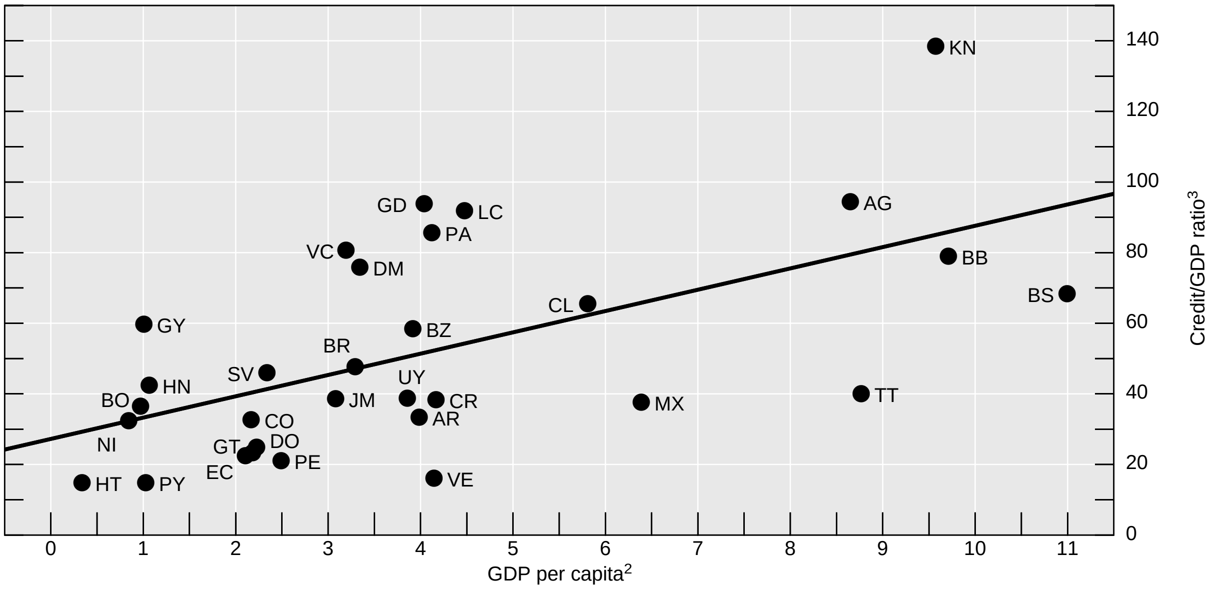
---

[1] The author is grateful to Angus Butler, Már Gudmundson, Gregor Heinrich, Madhu Mohanty, Ramon Moreno and Camilo Tovar for extensive comments. The views expressed are those of the author and do not necessarily represent those of the Bank for International Settlements.

[2] See Moguillansky et al (2004) for a more detailed discussion.

Graph 1.1

Bank intermediation and per capita income in 2004[1]



AG = Antigua and Barbuda; AR = Argentina; BB = Barbados; BO = Bolivia; BR = Brazil; BS = Bahamas; BZ = Belize; CL = Chile; CO = Colombia; CR = Costa Rica; DM = Dominica; DO = Dominican Republic; EC = Ecuador; GD = Grenada; GT = Guatemala; GY = Guyana; HN = Honduras; HT = Haiti; JM = Jamaica; KN = St Kitts; LC = St Lucia; MX = Mexico; NI = Nicaragua; PA = Panama; PE = Peru; PY = Paraguay; SV = El Salvador; TT = Trinidad and Tobago; UY = Uruguay; VC = St Vincent and the Grenadines; VE = Venezuela.

[1] Or earlier, if 2004 figures not available. [2] In thousands of current US dollars. [3] Domestic credit of deposit money banks.

Sources: IADB (2004); BIS.

Table 1.1

Financial depth by region, 1990s

Region	Number of countries	Credit to private sector (percentage of GDP)	Credit and market capitalisation (percentage of GDP)	GDP per capita, 1995 US dollars
Developed countries	24	84	149	23,815
East Asia and the Pacific	10	72	150	2,867
Middle East and North Africa	12	43	80	4,416
Latin America and the Caribbean	20	28	48	2,632
Eastern Europe and Central Asia	18	26	38	2,430
Sub-Saharan Africa	13	21	44	791
South Africa	6	20	34	407

Note: Values are simple averages for the regions for the 1990s.

Source: IADB (2004).

Aside from the negative impact of a series of economic crises since the early 1980s, this low depth of bank intermediation has been attributed to structural factors, such as a lack of information on potential borrowers, which is itself the result of inadequate auditing and accounting standards or the absence of credit information bureaus, and poor enforceability of creditors' rights in the event of delayed payment or default.

Given the relatively low level of per capita incomes and the large number of small family-owned businesses, lending by the commercial banking sector has also been narrowly focused. In spite of regulatory action to prevent the concentration of risks in bank portfolios, such as quantitative limits on lending to a single borrower/related parties or on holdings of securities, lending remains concentrated. It has generally been limited to the largest companies and the middle class in urban areas. Moreover, it has often been made to well connected entities.

In many countries bank portfolios also include a high proportion of government securities, which has probably induced some crowding out of the private sector. This is particularly true in the larger countries, such as Argentina, Brazil, Colombia, Mexico and Venezuela, as well as in some of the smaller economies, such as Barbados and Jamaica. This phenomenon owes its existence to a number of factors. In the case of public sector banks, recapitalisation in the second half of the 1990s often involved the replacement of non-performing loans by government securities. In the case of private sector entities, the series of financial crises and the consequent increase in default rates led to a shift of bank portfolios to "safer" government securities. In some cases, liquidity requirements forced banks to hold a certain proportion of their assets in the form of government debt. In others, regulations allowing banks to value bonds at face value created an incentive for them to hold government debt. Such large holdings of government debt have been an important source of market risk for banks.

Low efficiency of financial intermediation

The low level of development of the region's banking sectors is partly reflected in the high cost of banking services. LAC countries have high interest margins; these averaged about 8.5% in 1995-2002, compared with 5.1% in East Asia and the Pacific and 2.9% in developed countries (IADB (2004)).[3] Overhead costs as a percentage of assets averaged 4.8% over this period, compared with 2.3% in East Asia and the Pacific and 1.8% in developed countries.

The prevalence of high inflation in the past often meant that banks could earn high returns on government debt indexed to overnight rates (deposit rates were often lower and re-priced less frequently), which blunted their incentives to implement cost reduction measures. This may have been particularly the case in Brazil, where, in spite of a substantial reduction in inflation, intermediation spreads remain high. The issue of bank profitability is further discussed in Chapter II. Despite the relatively high spreads, bank profitability (as measured by returns on assets, etc) remains low because of high operating costs and the relatively high risks of bank lending in the region (Singh et al (2005)).

Limited economies of scale and diversification

The banking systems of smaller countries in LAC exhibit a number of specific features. First, banks in such economies are limited by the extent to which they can reap economies of scale (see Birchwood (2003) for evidence on the Caribbean). In particular, it appears that the

---

3 However, as shown in Table A1, the spread between deposit and lending rates is not simply related to the size of a country or to its level of GDP per capita. Even within the three largest economies, namely Argentina, Brazil and Mexico, this spread varies widely.

small size of banks often prevents them from introducing complex new technologies. This is often a constraint on their competitiveness. Second, in a number of countries the oligopolistic structure of banking markets limits competition, so that banks can maintain their profitability without innovating or improving their efficiency. Third, the narrow economic base of smaller economies, and particularly of their export sector, leaves them vulnerable to the economic cycle of their main trading partners and to swings in terms of trade, increasing the vulnerability of the banking sector (Birchwood and Nicholls (1999) and Narain et al (2003)).[4] Limited diversification and higher economic risks have constrained their access to international financial markets, as reflected in the higher risk premia often attached to their international liabilities. Fourth, even in the case where a small country hosts a large OFC, the financial activities related to that centre may not benefit the domestic financial sector given that regulations often separate the two market segments (Williams et al (2005)).[5] Progress in financial integration would be one way of reaping economies of scale in the region (see the sub-section on intra-regional financial integration).

Boom and bust cycles in lending

Credit growth in the region has been marked by boom and bust cycles, particularly in countries that have a low level of bank credit relative to GDP. Credit expanded sharply in the early 1990s but declined equally sharply after the banking crises of the mid-1990s.[6] It then remained subdued for many years and has begun to recover only recently (see Graph 1.2, right-hand panel and Chapter II).[7] Domestic financial liberalisation, the removal of capital account restrictions and the ensuing large capital inflows have all combined to generate strong lending booms. However, poor bank management and weak prudential regulation and supervision have exacerbated the problems faced by domestic banking sectors. In periods of easy credit availability, credit was often extended without adequate risk assessment. Overall, the volatility of credit growth has owed as much to macroeconomic imbalances and shocks as to a lack of instruments to prevent or deal adequately with the boom and bust pattern.

---

4 The problems created by lending to the volatile export sector have been compounded by the granting of foreign currency loans to the non-tradable sector, resulting in additional vulnerability in countries with floating exchange rates.

5 OFCs generally target non-residents and this means that the volume of non-resident business substantially exceeds that of resident business. Traditionally, OFCs have capitalised on a favourable fiscal status, banking secrecy and less stringent prudential norms. These advantages have supported the rapid expansion of wholesale market activities, such as securitisation operations conducted through special purpose vehicles and the trading operations of hedge funds. Of course, international pressure has now led many OFCs to take measures to deal with these deficiencies.

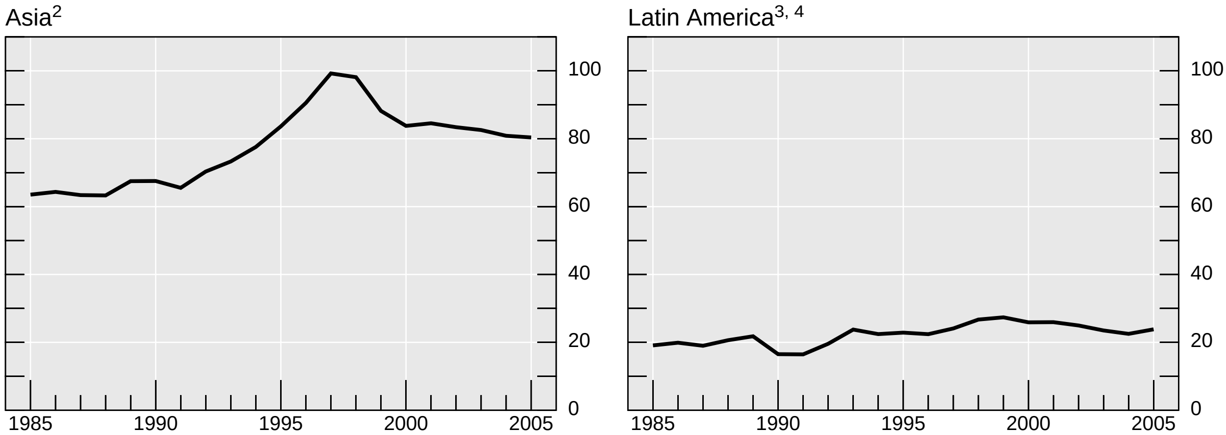
6 Compared with other regions of the developing world, LAC countries display the highest average number of crises per country (IADB (2004)). However, the incidence of crises has been lower in the Caribbean.

7 In Mexico, non-bank intermediation partly compensated for the weakness of bank intermediation. In Chile, a longer history of financial stability and early financial sector reform combined to create a more stable pattern of credit growth.

Graph 1.2

Bank credit to the private sector[1]

As a percentage of GDP



[1] Simple average of country data. [2] Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] Moving average of current and previous year private credit levels to current year GDP.

Sources: IMF; BIS calculations.

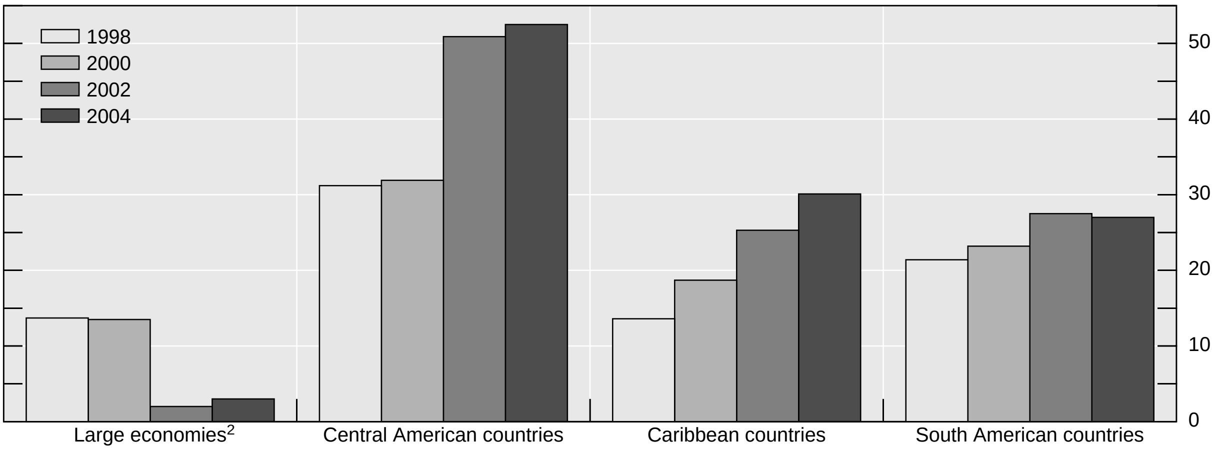
Several factors have favoured the recovery of bank lending in Latin America, including strong economic growth, easier global monetary conditions and progress in bank restructuring. In the region, the strong growth in nominal credit and the containment of inflationary pressures has led to an acceleration in real credit growth, which picked up from a year-on-year rate of 7% at the end of 2004 to almost 13% at the end of the first half of 2005. Credit growth was particularly strong in Argentina and Brazil, reaching over 20% in 2005, and also accelerated in several Caribbean countries. In spite of this acceleration, the ratio of credit to GDP remains below the level reached in the mid-1990s in a number of countries, including Bolivia, the Dominican Republic, Ecuador, Mexico and Paraguay (see Graph 1.1 and Table 1.1).

High level of dollarisation

The banking systems of most countries in Latin America are characterised by relatively large shares of bank deposits and loans denominated in dollars (see Graph 1.3 and Table A2). In some countries, such as Bolivia, Nicaragua, Paraguay, Peru and Uruguay, more than half of deposits and loans are denominated in dollars. In Ecuador and El Salvador, there has been a move to formal dollarisation. In other countries, dollarisation has resulted from a market-driven process of currency substitution (Bolivia, Paraguay, Peru and Uruguay). By contrast, a number of countries (Brazil, Chile, Colombia and Mexico) have countered dollarisation, either by a prohibition on most holdings of foreign currency deposits or by prudential constraints on such holdings. These restrictions have sometimes led to a shift of deposits and loans to OFCs. The financial crises in Argentina and Uruguay have made policy makers aware that dollarisation can add to the vulnerability of the financial system by increasing liquidity and solvency risks and by limiting the scope for an independent monetary policy.[8] Issues related to dollarisation are discussed in further detail in Chapters II and III.

Graph 1.3

Dollarisation ratios [1]



[1] Ratio of total foreign currency deposits to total deposits, in the domestic banking system, in per cent. [2] Argentina, Brazil and Mexico.

Source: Moody's Investors Service.

In many countries there has been a steady rise in dollarisation in spite of a generalised reduction in inflation and a shift in some countries to formal central bank independence. Views on the effect of dollarisation on the depth and structure of domestic banking systems diverge (Del Negro et al (2001) and De Nicolo et al (2003)). Nevertheless, in most countries where dollarisation has been a market-driven process, it appears to have encouraged residents to keep their savings in the domestic financial system. In the few countries that have moved to full dollarisation, there is some evidence that the resulting elimination of currency risk has also encouraged financial deepening.[9] It is difficult to quantify the extent to which this has been the case in Ecuador given the economic strains the country was facing when official dollarisation was introduced. However, in El Salvador the legal certainty pertaining to dollar-denominated transactions and the reduction in currency mismatches that followed the move to official dollarisation appear to have reduced the perception of risk in doing business with Salvadorean residents, with the result that the ratio of bank deposits to GDP has increased. Greater confidence in the solidity of the financial sector also appears to have reduced the attraction of offshore bank deposits. However, dollarisation may have provided a competitive advantage to foreign banks with cheaper access to dollar funding.

Structural changes in financial systems

Although commercial banks remain the most important source of credit supply in LAC countries, there have been significant changes in the structure of credit markets in recent

---

[8] The balance sheet effects of dollarisation have posed a significant threat to the stability of the financial system given that high dollar liabilities held by local currency earners create a significant exposure of the financial sector to default risk from exchange rate movements (Jeanneau and Tovar (2006)).

[9] Panama, of course, has one of the deepest banking sectors in the region owing to its long-standing status as an OFC.

years. These include the development of capital markets, deregulation, privatisation and foreign bank entry, the declining role of state-owned banks, market concentration and intra-regional financial integration.

Development of capital markets

The move to a more stable financial environment and the recent reforms to pension systems have helped to support the development of capital markets in the largest/most advanced countries in the region. Issuance of government bonds, particularly in local currency, has been strong in Brazil, Chile, Colombia, Mexico and Peru (Jeanneau and Tovar (2006)). The corporate sector is also turning to securities markets, although this process is much less developed than is the case for the government sector. In spite of these advances, however, the overall scale of bond and equity financing remains relatively small and markets are illiquid when compared with those of large and advanced economies. The lack of comparable cross-country data on smaller securities markets makes it difficult to compare the relative size of such markets in the region. However, available numbers on stock market capitalisation (see Table A3) show that outside of Barbados, Chile, Jamaica and Trinidad and Tobago, the ratio of stock market capitalisation to GDP remains below that observed in the United States, Japan and the euro area (114%, 85% and 57%, respectively).

Deregulation of banking systems

The banking sector in EMEs has traditionally been a highly protected industry. However, global competitive forces and banking crises in the 1990s forced market participants and the authorities to deregulate the industry and open it to domestic non-banks and foreign intermediaries. The removal of restrictions, such as ceilings on deposit rates, has led to a progressive switch to market-based monetary policy techniques that have made it easier for central banks to signal their intentions, guide the economy and better respond to shocks (Archer (2006)). It has also been a catalyst for stronger market competition and efficiency (Hawkins and Mihaljek (2001)). However, the process of deregulation has been followed in many countries by major banking crises. Poor bank management and supervision encouraged a rapid expansion of credit which was ultimately followed by mounting loan losses, an erosion of bank capital and an eventual collapse of financial institutions (Kaminsky and Reinhart (1999) and Demirgüç-Kunt and Detragiache (2005)).

Privatisation and foreign bank entry

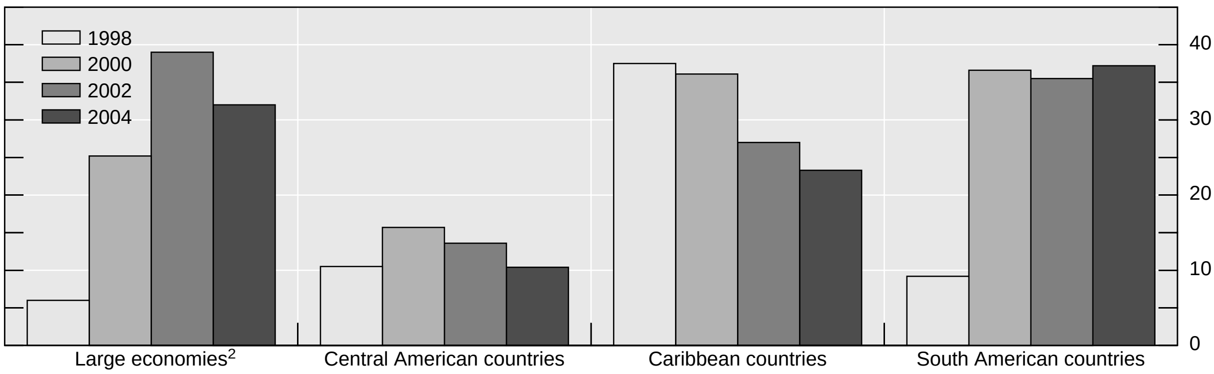
One of the most important consequences of the banking crises was a significant change in the structure of bank ownership. Fears of bank runs or of the collapse of banking systems led governments to intervene, either by nationalising the banks in trouble and then turning them over to private ownership or by encouraging domestic bank mergers or foreign takeovers. The entry of foreign banks was seen as a means of recapitalising weakened banking systems. Faced with limited growth opportunities in their home markets, banks from industrial countries quickly expanded their business in EMEs. This was particularly the case in Latin America in the years following the Mexican financial crisis of late 1994. Foreign direct investment in Latin America rose sharply afterwards and remained high until 2002 (CGFS (2004)). In many countries foreign banks became the main actors in local financial systems. In Argentina, Chile and Peru, foreign banks now account for more than 40% of domestic banking assets and in Mexico they account for more than 90% of such assets (see Graph 1.4

and Table A4).[10] In the Caribbean, by contrast, the increase in foreign bank penetration has tended to be less pronounced than in Latin America. The financial systems of most CARICOM territories have always tended to be quite open to foreign penetration, particularly in the OFCs, and foreign bank ownership already equalled or exceeded 50% in most countries in the 1990s.

The growing importance of foreign banks has raised crucial questions about their impact on local financial systems. Empirical evidence on this subject for LAC countries is limited (IADB (2003) and IADB (2004)). What is available suggests that exposure to global competition has led to an increase in financial sector competitiveness and efficiency (CGFS (2004) and Moreno and Villar (2005)). Generally, host countries have benefited from a transfer of technology that has been applied to both products and processes. In several countries, including Chile and Mexico, foreign banks have played an active role in the development of local financial markets, particularly in the areas of securities issuance and derivatives trading, which has enabled them to gain market share in the corporate sector. Foreign banks have also exerted demonstration effects on local institutions, often inducing them to reassess their business practices. This has resulted in better risk management, more competitive pricing and a more efficient allocation of credit by the financial sector as a whole. Of course, the beneficial role of foreign banks has varied with the degree of sophistication of local financial systems, with foreign banks probably playing a more useful role in less sophisticated markets (Levine (1996)).

Graph 1.4

Foreign bank credit[1]



[1] As a share of total domestic credit, in per cent. Credit in local currency granted by foreign-owned banks (includes cross-border credit and domestic credit to banks). For Brazil, Chile, Mexico (2004) and Panama, also includes credit in foreign currency granted by foreign-owned banks to the domestic non-banking sector. [2] Argentina, Brazil and Mexico.

Sources: IMF; BIS.

It is not entirely clear at this stage whether the greater efficiency induced by foreign banks has also been accompanied by a broader allocation of credit to the various sectors of the economy. Foreign banks have tended to enjoy lower overheads and have therefore been able to function with narrower intermediation margins, which may have translated into a better ability to extend cheaper credit to local borrowers. On the other hand, the emphasis of foreign banks on standardised credit evaluation models rather than on soft information

[10] This has been a general trend across the various regions of the emerging market world (Domanski (2005)). Foreign banks have become heavily involved in lending through domestic affiliates since the mid-1990s. The ratio of foreign banks' local claims in local currency to total foreign claims (international claims and local claims in local currency) has increased sharply in all regions. In Latin America, this ratio had risen to about 60% by the end of 2004.

criteria or long-term customer relationships may have altered the composition of lending towards sectors for which risk and return considerations can be more precisely established and/or managed, such as the retail and large corporate sectors (CGFS (2004)). Lending by foreign banks to small and medium-sized enterprises (SMEs) may have been affected to the extent that such firms have tended to be less transparent from an informational point of view (Berger et al (2001) and CGFS (2005)). From this vantage point, such behaviour would be indicative of shortcomings in the audit or legal infrastructure and should be of equal concern to both foreign and domestic banks. One significant impact of foreign bank entry, however, is that the incidence of connected or related-party lending has been reduced.

Declining role of state-owned banks

In part because of the low depth of banking markets and the narrow focus of lending, the state has tended to play a significant role in the financial sectors of EMEs. In the early 1990s, state-owned banks often accounted for over 50% of total banking assets in such economies. For most countries, the active role of such banks was usually justified by the need to deal with market failure, promote economic development or finance socially valuable activities. The financing of projects of importance to the national interest was also a significant consideration. However, it is not clear that state intervention was always the most appropriate means of addressing the problems identified by policy makers.

Views on the role of state-owned banks changed considerably during the 1990s. Governments came to realise that the existing governance structure was in large measure responsible for the poor performance and frequent collapse of such banks. In addition, there was a growing perception that the heavy weight of public sector financial entities was tending to hold back financial sector development. This perception was supported by empirical studies showing that the presence of state-owned banks was indeed associated with a lower level of financial development (Barth et al (2001) and IADB (2004)).[11] As a result, many governments embarked on a drive to privatise such institutions. By the end of the decade, the average share of state-owned banks in total credit had declined substantially in the region (Hawkins and Mihaljek (2001)).

State-owned banks have also adapted their lending strategies to compete more effectively with private and foreign-owned banks. In the past, such banks did not lend much to households, except in some cases under subsidised housing schemes. However, as competitive pressures increased and as public sector financial institutions became more business-orientated, they increasingly turned to the household sector, providing both consumer and housing loans. However, state-owned banks still lend disproportionately to the government. From a governance point of view, one might argue that the lack of independence of state-owned banks from their owners is similar to connected lending practices in the private sector and in principle would have to be sanctioned by independent supervisory authorities (Hawkins and Mihaljek (2001)).

[11] IADB (2004a), in particular, presents fairly negative evidence concerning the role of public sector banks in the economy. It finds that state-owned banks do not play a useful role in expanding credit availability or directing it towards sectors that require it the most. Focusing on access to credit by different sectors, the evidence provided suggests that the gap between small and large firms in their ability to access credit is higher in countries having strong participation by state-owned banks than in countries with low participation. Moreover, the presence of public banks seems neither to facilitate access to credit for SMEs, nor to favour access to mortgage credit. However, there is some evidence that state-owned banks provide cheaper and more stable credit than domestically owned private banks. A more positive recent view of state-owned banks is offered by Mihaljek (2006). He notes that foreign banks have contributed to the increase in lending to households and improved corporate governance practices.

Bank consolidation

Consolidation involving both domestic and foreign banks has led to a reduction in the number of banks in the largest countries in Latin America (Levy-Yeyati and Micco (2003)). In the Caribbean, by contrast, consolidation has proceeded at a slower pace. One of the reasons for this is that banking systems already had an important foreign component early on and that banking crises have been less frequent there than in the larger countries of the hemisphere.[12]

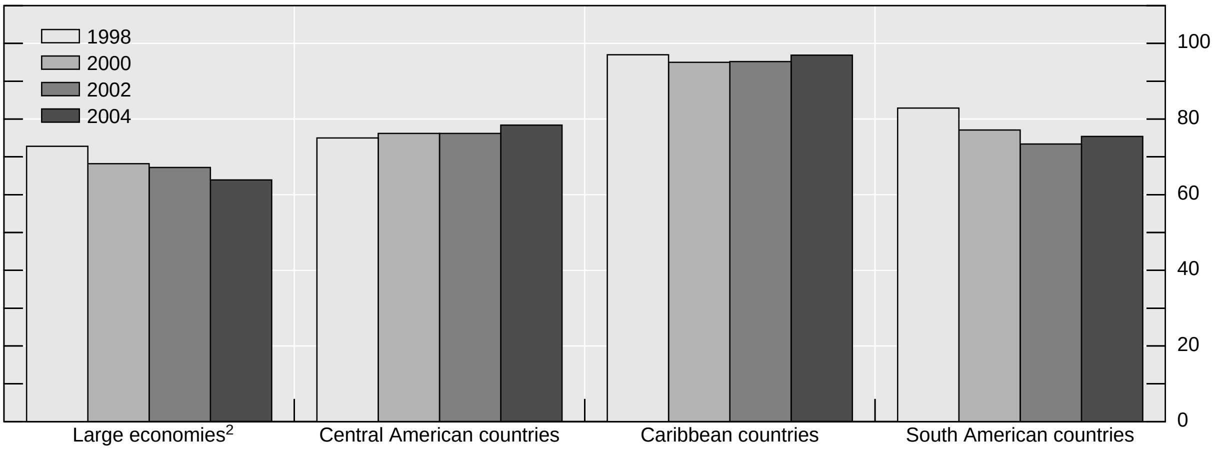
Some banking systems are now highly concentrated, with the five largest institutions accounting for between 57% and almost 100% of all banking assets (see Graph 1.5 and Table A5). There have been concerns that larger banking groups may have exploited their market power to pay lower rates on their deposits and charge higher rates on their loans. This concern is not entirely without foundation given the reportedly high costs of bank financing in the region. However, empirical work conducted by the IADB (2004) tends to indicate that there is no significant statistical relationship between concentration and bank profitability. In studies focusing on Latin America, Gelos and Roldos (2002) and Levy-Yeyati and Micco (2003) found no evidence that the reduction in the number of banks translated into less competition. The increase in concentration was largely due to technological innovation and financial liberalisation. The ensuing reduction in barriers to entry appears to have prevented an increase in market power, with the result that the cost of credit was apparently largely unaffected.

Concern has also been expressed about the impact of market consolidation on credit availability over the business cycle. According to some theoretical views, collusion could result in higher mark-ups during bad times, amplifying business cycle fluctuations (Rotemberg and Saloner (1986)). By contrast, other views suggest that low competitive pressures could help stabilise credit in bad times because banks could more easily afford to hold on to unprofitable business in the short term in the hope that such business might become more attractive again in the long term. In addition, some have argued that large banks are likely to be better diversified and therefore less affected by domestic shocks than their smaller counterparts. This would also help stabilise credit in bad times. Evidence gathered by the IADB (2004) shows that countries with more concentrated banking systems tend to enjoy less volatile credit.

[12] The number of banks in the CARICOM territories remained stable for much of the 1990s. However, it declined by 11% between 1998 and 2003 (Birchwood (2003)). This reduction resulted principally from mergers and acquisitions, including between the subsidiaries of foreign banking groups. Part of this activity was also encouraged by governments as a means of dealing with troubled banks, as in Jamaica after the crisis of 1996 and the Dominican Republic after the crisis of 2003.

Graph 1.5

Concentration of the banking system[1]



[1] Share of total assets held by the five largest banks in each country; unweighted average, in per cent. [2] Argentina, Brazil and Mexico.

Source: Fitch Bankscope.

Recent credit demand in emerging market countries

Strong household credit demand

Household sector credit demand has been unusually strong in several of the largest emerging market economies (see Table A6). Several demand and supply forces have been at work here. First, strong growth has not only boosted current household income, it has also countered the pessimistic expectations of future income that prevailed in the late 1990s. As predicted by the life-cycle model, this shift has been accompanied by a rise in the share of household expenditure in current income and in household demand for bank credit (see Table 1.2).

Moreover, in several countries recent financial liberalisation has involved the removal or substantial dilution of restrictions on bank lending to housing and consumer sectors. With household borrowing constraints thus relaxed, latent demand materialised.[1]

Second, the significant easing of monetary policy in a number of countries, combined with the progress made in reducing inflation, has brought down real short-term interest rates. In Latin America, in particular, real rates have been very low by historical standards (see Table A7). In turn, this drop in nominal and real rates has been accompanied by a reduction in lending margins charged to households. This reduction has been driven by several reinforcing developments. With inflation declining and becoming more stable, both inflation expectations and the inflation risk premium have fallen. This lower cost of credit has attracted potential homeowners to the mortgage market, not only by reducing initial debt servicing payments relative to income but also by increasing the affordability of housing for low-income segments of the population.

Lastly, governments have taken steps to encourage residential investment and borrowing-led household consumption as part of a strategy to revive domestic demand. Such incentives have taken several forms: preferential tax treatment of mortgage interest payments and capital gains from property transactions, temporary increases in loan-to-value ratios and the establishment of various housing subsidy schemes to promote low-cost dwelling units.

[1] Industrial countries witnessed a similar surge in demand for consumer and residential credit following financial liberalisation in the 1980s and 1990s leading to substantial relaxation of credit constraints facing households; see Bacchetta and Gerlach (1997).

Recent credit demand in emerging market countries (cont)

Weak corporate credit demand

The corporate sector in many emerging market countries appears to have reduced its demand for bank credit over the past few years. In Latin America, the stock of outstanding corporate loans in the seven largest economies declined by about 10 percentage points of GDP over the 1997-2003 period.

Table 1.2

Composition of bank credit[1]

	Housing credit			**Consumer credit**			**Business credit**		
	1994	**1999**	**2004**	**1994**	**1999**	**2004**	**1994**	**1999**	**2004**
Latin America									
Chile	13	17	21	8	9	12	79	74	67
Colombia		7	11		15	14		56	39
Mexico	17	16	9	7	4	13	62	36	28
Venezuela		4	1		18	7	44	55	47
Asia									
Hong Kong SAR	7	15	15	2	3	3	86	76	73
India			10			12		7	7
Indonesia		5	6		7	18		60	37
Korea		9	33		18	17		69	47
Malaysia	10	18	28		8	16		64	45
Thailand	9	7	10	4	3	6	64	71	68
Central Europe									
Czech Republic[2]		10	16		4	5		41	37
Hungary		3	17		6	8		62	46
Poland		2	10		21	23		44	35
Israel	0	0	8	15	10	9			
Turkey	0	0	2	2	3	6	76	58	39

[1] Commercial banks. As a percentage of total domestic credit granted by commercial banks. [2] The data in the 1999 columns refer to 2002.

Source: National data.

One explanation for weak demand for corporate credit is that overly indebted firms have sought to reduce their leverage as part of the restructuring process that followed the crises of the late 1990s and early 2000s.[2] Another is that firms have been diversifying their financing sources by issuing bonds and equities. There is some evidence in support of this hypothesis in Brazil, Colombia, Mexico and Peru. Moreover, with corporate profits rising, firms have been financing a large part of their investments through retained earnings. Easier external financing conditions have also encouraged firms to access the international syndicated loan and bond markets.

Sustainability of current trends

Can the recent rapid pace of lending growth to households be sustained? There are reasons to believe that household borrowing can continue to grow at a fast rate over the next few years. On the demand side, growing household income and the structural changes highlighted above can be expected to sustain demand for consumer and residential credit.

[2] See IMF (2000) and IMF (2004a).

Recent credit demand in emerging market countries (cont)

Also, credit to GDP ratios remain low in Latin America, particularly in comparison to Asia. On the supply side, the sustainability of household credit could be helped by the fact that residential and consumer lending provides banks with important diversification opportunities and higher returns. Some have argued that retail lending will increasingly become the main business line of banks in years to come, driven partly by financial diversification and partly by growing foreign bank penetration. Another positive factor has been the recent trend towards securitisation of household debt through the growth of mortgage-backed securities in a number of countries (Jeanneau and Tovar (2006)).

Nevertheless, the strength of the forces supporting the demand for and supply of household credit are such as to raise questions about the sustainability of its growth. Although household borrowing and real estate prices in the region are not yet considered to have reached levels at which they would represent a systemic threat, the experience of other regions that have seen a rapid rise in household credit, such as Asia, underlines the need for close monitoring of markets by prudential authorities, especially given the relative inexperience of borrowers and lenders with the performance of new financial instruments over the cycle.

Intra-regional financial integration

Advances in formal financial integration in the region have been limited given that most initiatives have focused on trade in goods rather than trade in services (IADB (2003)). The best known effort involving financial services is NAFTA (the North American Free Trade Agreement), which came into force in 1994. NAFTA contains a number of principles to enhance financial market access. In addition, the members of CARICOM agreed to create a single market and economy entailing the removal of obstacles to trade in goods and services, the end of restrictions on capital movements and greater coordination in macroeconomic policies. Some CARICOM countries (Barbados, Jamaica and Trinidad and Tobago) have moved towards a regional stock market, with cross-listing and trading in securities on existing exchanges. The Organisation of Eastern Caribbean States, part of CARICOM, shares a common currency and central bank.

Despite the limited nature of advances in formal financial integration, there has nevertheless been some evidence of de facto intra-regional integration in Central America and the Caribbean. In Central America, a number of financial institutions that originally focused on the home market have expanded throughout the region by establishing new offices, branches or subsidiaries (Rodlauer and Schipke (2005)). Cross-border expansion has also taken place through informal ownership relations, such as parallel banks.[13] The percentage of assets held by regionally operated banks is particularly high in El Salvador, Nicaragua and Panama. In the Caribbean, where local banks have been able to hold their own in the face of competition from foreign banks, indigenous banking groups from the larger economies have managed to expand their cross-border activities. For example, banks headquartered in Trinidad and Tobago have carried out acquisitions in the sub-region.

This process of intra-regional integration could generate important benefits for the banks involved. Larger entities will be able to enjoy economies of scale and diversify their portfolios

[13] Entities that have the same beneficial owners and consequently often share interlinked businesses, although they are not part of the same financial group for regulatory consolidation purposes (see BCBS (2003a,b)). The existence of such structures contributes to deeper integration than would be implied by a simple consideration of the most common forms of establishment.

across countries. However, it could also bring new risks as banks enter into markets that have different risk characteristics and regulatory regimes (Rodlauer and Schipke (2005)). Moreover, this process has also created some concerns for bank supervisors to the extent that one of the motives for cross-border expansion has been the exploitation of regulatory arbitrage opportunities. Cross-country differences in capital, reserve and liquidity requirements are sufficiently large to make arbitrage enticing. Differences in prudential requirements could also encourage adverse selection to the extent that weak banks could opt to establish holding companies in less well supervised jurisdictions. Such developments could limit the capacity of countries to regulate their financial systems and would warrant increased cooperation between regulators along with a greater harmonisation of supervisory rules.