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Introduction

Banks play a key role in the allocation of economic resources and, therefore, in economic development. This is particularly true in LAC because the banking sector has historically dominated the region's financial landscape. However, this sector has been characterised by significant shortcomings, such as the limited depth and narrow focus of intermediation, low efficiency and limited economies of scale and diversification. Furthermore, the banking systems of many countries in the region have experienced sharp boom and bust cycles and frequent crises which have done their part towards exacerbating economic fluctuations. Idiosyncratic features, such as the high level of dollarisation prevalent in a number of countries, have further aggravated fluctuations.

In recent years, the banking sectors of many LAC countries have undergone rapid structural change. As discussed in Chapter I, an important underlying determinant of such change has been the drive by countries to improve the efficiency and resilience of their financial systems through deregulation, the development of domestic capital markets, the privatisation of state-owned financial entities and the encouragement of foreign bank entry. Another determinant has been a market-driven process of consolidation, regional financial integration and overall financial innovation. As a result of this evolution, market forces have come to play a greater role in credit allocation and the underlying structure of financial systems has often undergone significant transformation. These changes have been accompanied by a revival of credit growth, in particular in the consumption and housing segments, as banking sectors have returned to a measure of health on the back of stronger economic activity.

While the changes just discussed are helping countries move to a better allocation of financial resources, Chapter II argues that they have also brought new and more complex risks. With interest rates and financial flows being more closely determined by the interplay of demand and supply, both domestically and internationally, financial systems may have become more vulnerable to market risks. This is an issue of particular relevance for smaller economies, for which limited economic and financial diversification may have complicated the management of financial market volatility or shocks. The introduction of new products, rules and market structures has also influenced the evolution and distribution of lending across economic agents and sectors, leading to the emergence of new credit, liquidity and market risks. A key issue in this context is whether financial institutions now have a better capacity to cope with this new constellation of risks. Risk management appears to have improved in most sub-regions as a result of the introduction of new approaches to the allocation of credit as well as better measurement and pricing of the various risks. These improvements appear to have strengthened the health of the region's banking sectors. However, as will be discussed in Chapter IV, weaknesses persist.

The transformation of the banking industry and, in particular, the shift to a more market-determined process of intermediation has also had implications for central banks to the extent that it has affected the effectiveness of monetary policy instruments, the relative importance of the different transmission channels and/or their ability to react to non-policy shocks. Chapter III highlights two key developments: first, that the transformation just noted has been accompanied by a shift from direct to market-based instruments; and second, that there is tentative evidence of a decline in monetary control as reflected in a weaker transmission mechanism. However, further research will be required in order to reach a more decisive conclusion on this matter. In this context, a key issue for monetary policy is whether central banks should adapt operating procedures to the transformation of the financial sector or lead the change by adjusting their procedures beforehand. Although there is no clear consensus on this issue, it is possibly the case that in some economies in the region, in particular the smaller ones, proactive adjustments to operating procedures are leading those brought about by structural change.

Chapter IV examines how the development of the banking sector, and in particular foreign bank entry, has affected a wide range of prudential issues. In recent years, for instance, bank

supervisors in some of the most advanced countries have developed sophisticated approaches to monitoring banking systems and made strong efforts to enhance the quality of supervision. In others, however, the improvement to the regulatory environment has been less impressive. In a number of countries, progress in implementing the Basel Core Principles for Effective Banking Supervision (BCPs) has been limited and much effort is still required in areas such as consolidated banking supervision, measures of bank performance and capital adequacy, and overall quality of risk management. Compliance with the BCPs would do much to address such weaknesses. In fact, the Basel Committee on Banking Supervision (BCBS) has stated that one of the key conditions for successful implementation of Basel II will be compliance with the BCPs.

This publication provides an overview of the issues discussed at a meeting of central banks in Kingston, focusing on the open economies of LAC. As such, the intention is not to provide an exhaustive analysis but rather to flag relevant issues and views. During the preparation of this document a large amount of data on financial systems were collected. Such data are often not easy for policy makers and researchers to assemble and, for this reason, they are being made available to a larger audience in the form of tables attached at the end of this document. Hopefully, they will be of use to anyone interested in the financial evolution of smaller banking and financial systems in LAC.

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