

ACKNOWLEDGMENTS

The Report on *Economic and Social Development in Latin America* is prepared by the Research Department of the Inter-American Development Bank, under the direction of the Chief Economist, Guillermo Calvo. Arturo Galindo, Alejandro Izquierdo, and Alejandro Micco, with the collaboration of Mauricio Olivera, were responsible for the coordination of this edition.

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The following individuals participated in valuable discussions during the production of the Report: Manuel Agosin, Mauro Alem, William Armstrong, Jorge Canales-Kriljenko, Stephen Cecchetti, Carolin Crabbe, Augusto de la Torre, Rosina de Souza, Saul de Vicente, Eduardo Fernández-Arias, Luis Fierro, Franco Fornasari, Rafael Franzini, Alicia García-Herrero, Manuel García-Huitrón, Luis Giorgio, Max Gómez, Felipe

Gómez-Acebo, Hunt Howell, Alain Ize, Ronulfo Jiménez, Juan José Llisterri, Elio Londero, Tomás Miller, Alexander Monge, Lionel Nicol, Frank Nieder, Javier Ortiz, Stephan Queck, Claudio Raddatz, William Savedoff, Graciela Schamis, Sergio Schmukler, José Seligmann, Hans Shulz, Abraham Stein, Roberto Steiner, Claudia Suaznabar, Patricia Torres, Carlos Valencia, Andrés Velasco, and Guillermo Zoccali. The authors also thank Bank staff who participated in internal discussion workshops on background papers for the Report, and who provided comments during revisions.

Research assistance was provided by Paula Auerbach, Cecilia Calderón, Carlos Díaz Alvarado, Carlos Andrés Gómez-Peña, Erwin Hansen, Ana María Loboguerrero, Rudy Loo-Kung, Carolina Mandalaoui, Danielken Molina, Javier Okseniuk, Christian Pardo, and Mónica Yañez.

Translation, Editing and Production

The IDB's Office of the External Relations Advisor was responsible for the editorial production of the Report. Larry Hanlon (English); Álvaro Correa, Roberto Donadi, María de los Ángeles Ochoa, and Carlos Tripodi (Spanish); and Cecilia Camargo Bartalotti, Donaldson Garschagen, and Pedro Medeiros (Portuguese) translated the text. Sandra Gain (English), Claudia Pasquetti (Spanish), and Eloisa Marques (Portuguese) edited the Report. Cathy Conkling-Shaker and María Clara Sarcione provided valuable editorial assistance, and Laura Clavijo, Julia Gomila, John Smith, and Leigh Tripoli proofread the volume. Leilany Garron and Dolores Subiza created the cover and graphic design and typeset the volume.

The views and opinions expressed in this Report are those of the authors and do not necessarily reflect the official position of the Inter-American Development Bank, its Board of Directors, or the Editorial

UNLOCKING CREDIT

The Quest for Deep and Stable Bank Lending

©2004 Inter-American Development Bank
1300 New York Avenue, NW
Washington, DC 20577

Distributed by

The Johns Hopkins University Press
2715 North Charles Street
Baltimore, MD 21218

To order this book, contact

IDB Bookstore

Tel: 1-877-PUBS IDB / 202-623-1753

Fax: 202-623-1709

E-mail: idb-books@iadb.org

www.iadb.org/pub

ISBN: 1-931003-66-1

ISSN: 0095-2850

Cover photo: Getty Images



Printed on
recycled paper
E.C.F.

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PREFACE

Credit supplied by the banking sector is the most important funding source for firms and households in Latin America and the Caribbean. Unfortunately, credit is scarce, expensive, and volatile. Without deep and stable credit markets, it will be very difficult for the region to achieve high and sustainable growth rates and combat poverty.

The past few decades have been a period of continuous transformation in the Latin American banking sector. During the 1970s, much of the financial system was repressed, and the government had a prominent role in financial activity. After a brief period of financial liberalization and some privatization, in the 1980s most financial systems faced deep crises that forced governments to intervene and increase public ownership. By the late 1980s, great concern about bank regulation and supervision had spread worldwide, with an important impact in Latin America. A new wave of financial sector reform and privatization materialized once again, this time in a context of stronger prudential regulation and supervision. By the mid-1990s, bank credit was growing at historically remarkable rates, following a surge in capital inflows. Nonetheless, crises hit again in many countries during the second half of the decade. By the beginning of the new century, banks remained weak and credit stagnated. What went wrong? If deep and stable bank lending was a priority, what piece of the puzzle was still missing?

The stability of credit markets as well as their size and accessibility have long been a concern of the Inter-American Development Bank and its Research Department. Throughout the mid and late 1990s, the Bank was a leading voice in the analysis and understanding of banking crises. Views on this issue have changed and much has been learned. Both Bank research and operational experience have led us to rethink how to integrate into the global financial market, how to design appropriate prudential rules that deal with vulnerabilities that are spe-

cific to the region, and how to cope with external shocks such as sudden stops in international capital flows, which were not incorporated previously in the analysis of banking crises. The 2005 edition of *Economic and Social Progress in Latin America* summarizes many of those lessons, providing different points of view that, hopefully, will be useful for bank regulators and supervisors.

While coping with domestic and international macroeconomic volatility is one of the main tasks to achieve deep and stable lending, there are many other institutional factors that are crucial as well. One is the design of an adequate financial safety net defining clear tasks for the central bank, the deposit insurance agent, the market, and the banking system's regulators and supervisors. However, other ingredients in the institutional prescription go beyond financial institutions. The effective protection of property rights (particularly creditor rights in bankruptcy procedures) is a key area where much still needs to be done in Latin America and the Caribbean in order to better exploit the benefits of credit markets.

A topic of great controversy regarding the characteristics of the banking system is its ownership. Latin America and the Caribbean has switched from one extreme to the other several times in the past decades, both in practice as well as intellectually. Banks have switched from private to public hands and vice versa repeatedly, and, recently, foreign banks have become the main players. The intellectual debate in this area has been extremely polarized. An objective of this Report is to balance extreme views in order to learn what can be gained from alternative sources of ownership, and to understand the real trade-offs involved, refraining from an ideologically driven debate.

Small and volatile credit markets are harmful to all. However, certain groups are more vulnerable to credit restrictions. The Report emphasizes two

of them—small and medium-size enterprises, and households that require mortgage credit—that represent a segment of society that is crucial to attend to in order to promote economic growth and increase overall social welfare.

The 2005 Report contributes to the identification of Latin America and the Caribbean's main challenges in the banking sector, and to the analysis, understanding, and design of prescriptions for

financial sector policies that promote deeper, more stable, and accessible credit. Far from being the last word on a topic that generates much discussion, it gives readers a better understanding of credit markets in Latin America and the Caribbean and of the major sources of vulnerability in the region's banking systems, and proposes new ideas regarding policy directions to improve the well-being of Latin Americans.

Enrique V. Iglesias

President

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