

The banking system in emerging economies: how much progress has been made?

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Introduction

The first annual meeting of Deputy Governors from the emerging markets took place at the BIS in February 1995. It had as its central focus the challenge to central banks (and supervisors) as countries moved towards a more liberal banking system in the context of wider capital account convertibility. There was at that meeting a common sense of unease about short-term capital flows, a good deal of scepticism about exchange rate pegs, and much debate on what could be done to improve the resilience of banking systems to external shocks. The Mexican crisis of December 1994 had given these worries particular urgency.

A similar meeting at the BIS held almost exactly one year later focused squarely on strengthening the banking system in developing countries. It was chaired jointly by the General Manager of the BIS, the First Deputy Managing Director of the IMF and the Chairman of the Basel Committee.¹ The conclusions echoed many of the worries that had surfaced in 1995. The process of bank supervision in very many countries was inadequate, and in particular had not kept up with the rapid pace of liberalisation of financial markets worldwide. Substantial macroeconomic imbalances often exacerbated financial system fragility. Equally, weak financial systems undermined the effectiveness of monetary policy.

At about this time, the Basel Committee was called upon to take the major step of developing internationally accepted guidelines to help to improve the quality of prudential oversight worldwide. The Committee issued a consultative document on the Core Principles for Effective Banking Supervision in April 1997.² Several other international reports and initiatives of this period also focused on strengthening banking systems. One report by a group of officials from 16 developing and developed countries was particularly influential in spelling out what was needed in addition to improved banking supervision - work on the quality of the legal framework, macroeconomic policies, and the way other parts of the financial system were regulated.³

These themes were also stressed in several BIS reports at that time.⁴ The BIS *Annual Report* prepared in early 1997 noted that central banks and other supervisory authorities in Asia had sought to tighten prudential guidelines on the extension of bank credit, particularly where asset prices had been driven up by excessive speculative pressure.⁵ But these attempts to instil greater caution into bank lending proved inadequate, and substantial macroeconomic imbalances were allowed to persist. In June 1997, the crisis in Thailand unleashed yet another round of major banking crises throughout the emerging market world. These crises had dramatic consequences domestically and caused major upheaval internationally. In most cases, they went hand in hand with massive macroeconomic disruption: sharp increases in interest rates, substantial currency depreciation and dramatic deflation of domestic demand. All this led to a contraction in bank intermediation that was, in many countries, unprecedented in recent history. The demand for credit fell because of recession and the greater reluctance of borrowers to become indebted. At the same time, the supply of bank credit declined: banks became more risk-averse and a major stiffening of supervisory oversight reinforced this effect in many countries. This shrinkage of bank intermediation was greater and lasted longer than after comparable crises in the industrial world.

¹ Goldstein and Turner (1996) originated as one of the background documents for this meeting.

² The final paper is BCBS (1997). In April 2006, the Basel Committee issued a new consultative document suggesting some modification or elaboration of the earlier principles.

³ See Draghi et al (1997).

⁴ See, in particular, White (1996).

⁵ See BIS (1997), "Financial fragility in Asia", pp 107-17.

During the past few years, however, much of this shrinkage in bank intermediation has been reversed. By 2004 and 2005, bank credit was rising very rapidly in many countries. Perhaps even more importantly, the reforms that had their roots in the mid-1990s had led to a significant overhaul of financial regulation in many countries. Financial markets domestically had been further developed, and financial firms had become subject to more rigorous market discipline than had been the case in the 1990s. An equally radical change is that the internationalisation of financial services and capital markets is now viewed in a more positive light than was the case a decade ago.⁶ This change of mindset and ambitious programmes of reforms appear to have contributed to substantial structural strengthening of the banking system in emerging economies.

The time thus seemed ripe for a stocktaking of just how much progress had been made. The 11th annual meeting of Deputy Governors, which took place on 8 and 9 December 2005, therefore examined the health of banking systems in emerging markets.

Five issues were addressed:

1. How is the supply of bank credit changing - both in aggregate and in composition?
2. Is the pace of structural change, which was very intense around the turn of the decade, beginning to slacken?
3. How are the risks facing banks evolving, and how are they being managed?
4. Are policies to prevent systemic banking crises stronger than a decade ago?
5. What are the implications of the changing shape of financial intermediation for monetary policy?

This volume contains papers from 19 central banks (those of Argentina, Chile, China, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, the Philippines, Poland, Saudi Arabia, Singapore, Thailand and Turkey) and five papers by BIS staff.

1. The supply of bank credit

The paper by Mohanty et al in this volume shows that aggregate bank credit to the private sector (expressed as a percentage of GDP) in both Asia and Latin America peaked in the second half of the 1990s and has only recently begun to rise again. This empirical analysis shows that demand factors (eg the output gap and the level of real interest rates) and supply factors (eg the level of non-performing loans and the deposit base) have both exerted significant influence on recent developments.

The share of bank credit going to the business sector has declined across the board. A main cause appears to have been lower corporate demand for funds as investment ratios declined and corporate balance sheets were restructured. Several meeting participants noted that financial crises had led to a rise in corporate and bank risk aversion that has endured much longer than expected. Fears of legal action have in some cases accentuated this effect. In some countries, firms continued to build significant "liquidity buffers" long after economic growth had resumed.

In addition, highly rated firms are increasingly able to borrow directly in domestic and international capital markets, reducing their reliance on banks. This change has been driven by several forces, including the recent development of domestic bond markets and the growing role of mutual funds in intermediating household saving through equity markets. Capital markets may have provided a useful opportunity for firms to lock in long-term funds at relatively low interest rates. It was agreed that the increased diversification of corporate financing sources is welcome insofar as it reduces the concentration of risk in the banking system and encourages corporate transparency. Banks may also ultimately gain from such diversification by increasing their fee-based income. In addition, in some countries banks have recently focused their attention on lending to the small-scale business sector, where credit quality appears to have improved. Nevertheless, several participants voiced a general

⁶ Mishkin (2006) makes a particularly lucid case for the benefits of financial globalisation.

concern that credit flows to small and medium-sized firms remain inadequate, with the authorities in many countries trying to get banks to increase such lending.

One important dimension of the increased risk aversion of banks has been their appetite for low-risk liquid assets. There has been a substantial accumulation of holdings of government or central bank securities in several countries. Increased issuance of government securities has in recent years had many counterparts: larger fiscal deficits; bank recapitalisation; the increased local currency financing of budget deficits (as part of a strategy to reduce foreign currency borrowing); and various capital account operations (eg to finance forex intervention by central banks). There is some evidence that changes in credit to the government have an influence on bank lending to the private sector. In any event, one consequence is that banks now face increased interest rate risk: yields on government bonds have fallen steadily for several years (generating capital gains for the banks) and are now low.

As corporate lending has declined, bank lending to households has increased. There have also been cases where reduced lending to the government sector has released resources for household lending (a “crowding-in” effect). In oil-exporting countries, a particular factor has been the rising oil revenues, which have led to high rates of credit and monetary expansion. A progressive decline in inflation rates associated with lower inflation expectations has brought down nominal interest rates. Real rates have also fallen. This has provided a particular stimulus to mortgage lending as such borrowing tends to be very interest rate sensitive. These cyclical elements have been reinforced by financial liberalisation and the development of securitised products. Credit constraints on households, very severe in some countries, have been eased considerably.

Does the recent rapid expansion of credit to households create serious risks for banking systems in view of linked information on specific borrower risk profiles and continued weaknesses in collateral arrangements? The balance of opinion at this meeting was that such risks are generally manageable. The development of information collection and sharing mechanisms over time should contain these risks: to this end, many countries have recently established credit bureaus. Moreover, increased credit to households from a very low base helps to improve the diversification of banking assets. In any case, the non-performing loan ratio for household lending is low. Several participants also thought that banks had sufficiently collateralised their housing loans, and increases in property prices have so far been moderate.

Some participants, however, warned against complacency. One recurrent theme was that greater competition (from foreign banks and from non-bank lenders) may in some countries have led to an unwarranted easing in lending standards, often involving a marked compression of bank intermediation spreads. A second worry is that banks have transferred an increasing share of market and exchange rate risks to households by extending long-term loans at variable interest rates and in foreign currency. This means that banks are less exposed to such market risk than earlier. One participant stressed that banks need to be strong enough to withstand shocks from monetary policy: warnings about near-term rises in policy rates had been used to encourage banks to move away from fixed rate mortgages. The converse is that household balance sheets are now much more exposed to interest rate and exchange rate risks. How aware households really are of these risks is unclear. Some participants observed that certain behaviour (eg borrowing in foreign currencies to secure quite modest interest rate advantage) suggests a worrying lack of awareness. A modest rise in interest rates (or fall in the exchange rate) would hurt households, and private consumption would weaken. Nevertheless, loans would still be serviced. The impact would thus be on the macroeconomy and not on the soundness of the banking system. A rise large enough to make some households insolvent would be more dangerous.

A final observation is that banks retain their dominant share in the credit market in most countries, and in some cases this share has grown. Weaker non-banks have in many cases been weeded out by crises; and competitive restrictions on banks have been eased in efforts to strengthen financial systems. But several countries have also seen non-bank financial institutions assume a growing role, particularly in the retail loan market. In some countries, non-bank financial intermediaries (sometimes with government guarantees) have filled the gap created by the withdrawal of banks from the mortgage market following a crisis. In others, non-bank intermediaries have increased their market share by specialising in niche markets such as credit card products. There was some concern that the rising share of non-bank financial intermediation in the credit market could lead to some underpricing of credit risk and might create problems, since such institutions may not be adequately regulated and supervised by the authorities.

2. Slower structural change?

The banking systems in emerging markets have over the past decade been transformed by three major trends - privatisation, consolidation and the entry of foreign banks on a large scale. Mihaljek's paper in this volume carefully examines these trends, and uses several indicators to gauge how this process has affected performance. He finds that performance has improved in all major types of bank: pre-tax profits have increased and operating costs declined similarly for state banks, for private domestic banks and for foreign-owned banks. Hence it appears that the creation of a more competitive climate has spurred all types of banks to improve performance.

There was nevertheless general agreement that the pace of structural change in emerging market banking systems had stabilised over the past five years. This was not because of reform fatigue, several argued, but rather because much of the easy work had already been done. Furthermore, a greater variety in the approach to structural reform seems to have emerged.

Regarding privatisation, large countries such as China and India are only gradually transferring ownership of major state-owned banks to the private sector. China is diversifying the ownership of such banks and not necessarily privatising. It is relying on corporate governance reforms related to the planned listings of three large state banks to improve their performance. Some countries have sought to improve the operations of badly run state or local banks by adopting better governance mechanisms without necessarily changing ownership. In India, for example, the authorities have modified earlier plans to increase the share of private ownership in public banks, partly because of opposition in parliament. Elsewhere in Asia, it has been difficult to attract strategic investors in state-owned banks without costly recapitalisations and without offering investors various guarantees against hidden losses. The remaining state-owned banks in other emerging markets have generally improved their governance and performance, and are often playing a useful role in the allocation of credit to certain sectors of the economy (eg in central Europe), or in the transmission of monetary policy (eg in Chile).

Several approaches to consolidation were identified. One was the hands-off, market-driven approach common in central and eastern Europe and Latin America. Another was the government-driven, financial "master plan" approach in parts of Asia. In Russia, for instance, takeovers and closures of smaller banks have resulted from greater competition for the household segment of the market from medium-sized banks, which were in turn squeezed out of the small and medium-sized enterprise (SME) segment by large banks. In central Europe, bank consolidation reflects to a large extent M&A activity among parent banks in the European Union. In Asia, on the other hand, the "master plan" approach has often been considered necessary because banking systems in many of the region's countries are still highly fragmented: most smaller banks are owned by individuals who do not want to give up ownership without special government incentives. Most participants did not consider increased concentration a threat to competition, and many thought that larger banks were better able to diversify and manage risks - and so make the financial system stronger. But it was noted that problems could arise if competition was restricted on a regional level, or if bank exposures became too concentrated. Potential conflicts of interest were also identified as an issue: bank ownership of investment funds creates such a conflict in the advice banks give to their customers about such products.

The role of foreign-owned banks has become dominant in central and eastern Europe, but remains limited in Asia. In Latin America (with the exception of Mexico), foreign-owned banks have been less successful in expanding market share than private domestic banks. In central Europe and Mexico, the increased role of foreign-owned banks has brought many benefits. The banking industry has become much more efficient, and credit allocation has greatly improved. This was not the case a decade ago. One view, however, was that foreign banks tended to be more oriented to the household sector (where they could apply their credit scoring technology and spread their risks over a large number of borrowers), and less oriented to small business than domestic banks had been. Nevertheless, the general consensus was that all clients - including the SMEs - now had access to bank credit.

The main drawbacks seen here were that foreign-owned banks were politically difficult to defend (they were often viewed as being too profitable) and difficult to supervise. In particular, subsidiaries of foreign-owned banks often behaved like branches, which limited host supervisors' access to bank management and information. This issue was a special concern in countries where foreign bank subsidiaries were systemically important. Participants agreed that in such circumstances it was more

important to have good working relationships with home country supervisors than to rely on an elaborate legal framework for cooperation. Another problem was the loss of market information from the delisting of large commercial banks from local stock exchanges after their takeover by foreign-owned banks.⁷

3. Managing new risks facing banks

Two general conclusions emerged in the debate about managing the new risks facing banks. The first was that the nature of macroeconomic risk has changed radically. It was clear that the external vulnerabilities (often the result of imprudent macroeconomic policies) that had so aggravated earlier banking crises appeared to have greatly diminished. Yet some participants thought that certain domestic macroeconomic risks were now more serious than a decade ago. The second broad conclusion was that bank lending was now informed by much better risk assessment and management procedures. At the same time, some of the modern techniques were giving rise to new risks, which were not always easy to quantify.

Macroeconomic volatility, traditionally higher in the emerging market countries than in the industrial world, has fallen sharply across the emerging market world. As the paper by Moreno demonstrates, various standard measures of external vulnerability have also declined sharply: perhaps as a result of this, sovereign credit spreads have narrowed. It was recognised, however, that part of the improvement seen in 2004 and 2005 reflected the mix of strong global growth and high commodity prices - an unusually favourable combination for many developing countries. But many felt that the main cause was more prudent macroeconomic policies in most emerging market countries. The higher levels of foreign exchange reserves, more flexible exchange rate regimes, the development of domestic debt markets and the reversal of the worst fiscal excesses were all cited as policy changes reducing external vulnerabilities.

A particularly important achievement in some countries was the development of local currency debt markets. This had enhanced the resilience of the financial system by making it less costly for banks to adjust their portfolios in response to shocks, and by imposing market discipline on the government (because lax fiscal policies then led to upward pressures on interest rates). But it was also noted that such markets could also transmit shocks from global financial markets more readily. One participant observed that a shift from bank intermediation (fixed nominal value of debts) to capital market intermediation (capital values market-determined) meant that wealth effects of a market correction would be much greater. It was not clear that either banks or supervisors were taking enough account of this macroeconomic risk, which is now common in emerging markets.

A survey of central banks (reported by Moreno in this volume) reveals that central banks share the view that external vulnerability has been much attenuated over the past decade. But the survey also revealed that central banks are more worried by three domestic macroeconomic elements - domestic demand, interest rates and property prices.

The risk of further rises in oil prices was singled out by several participants as a threat to domestic demand - not only directly but also because the wider inflationary consequences could necessitate steeper increases in policy interest rates than was currently expected. There were rather widely shared worries that increased holdings of longer-duration debt were exposing banks to significant interest rate risk. The discussion on property prices suggested that there was no strong evidence of any general overvaluation. Several noted, however, that better data and more systematic monitoring of households' balance sheet position would be desirable.^{8, 9}

⁷ See CGFS (2004, 2005) for a further analysis of the impact of foreign-owned banks.

⁸ The recent CGFS report on housing finance (CGFS (2006)) provides a comprehensive overview of these issues.

⁹ See Graph 2 in Moreno in this volume. More than half of the 14 respondents said that they saw a high probability of significant harm to the financial sector in the case of a large shock. Moreover, this reading was much higher than their assessment of the risk 10 years earlier.

Although macroeconomic risks seem less menacing now than earlier, the discussion brought several worries to the surface. First, a large devaluation could have strong contractionary effects in dollarised (or “euroised”) economies and could hurt the banking system. Second, fiscal positions in some cases were still fundamentally unsound. Third, avian flu posed a hard to quantify risk. Finally, the very high level of foreign exchange reserves in some countries caused some unease, and suggested certain fundamental weaknesses. Continued and large-scale reserve accumulation involved delaying adjustments to medium-term market forces, which has evident dangers.

The second main conclusion was that banks’ lending decisions were increasingly based on serious risk assessment procedures. The influence of government direction and relationship-based lending had diminished. In addition, taking collateral was no longer seen as obviating the need for properly assessing the creditworthiness of the borrower.

The survey of central banks described in Moreno’s paper shows (see especially Graph 5 in that paper) that the use of various quantitative risk management techniques by banks in emerging markets has expanded significantly. Valuations are increasingly based on market prices; market risks are quantified, mainly using VaR calculations; scoring models are used to assess the credit risks of households and of small business borrowers; portfolios are stress-tested for various adverse scenarios; in addition, both the pricing of, and the provisioning for, credits are increasingly based on quantitative risk assessments. The board of a bank in the emerging markets increasingly focuses on detailed quantitative reports in the oversight of its bank’s risk exposures.

Efforts to instil greater rigour into risk assessment are probably beginning to bear fruit, and this means that risks are being better managed in most emerging markets. Even so, implementation is not without its challenges. Three such challenges related to risk management processes were identified in the discussion. The first was the lack of data on loan histories over many years for estimating default probabilities. The use by some foreign banks of default probabilities derived from their home country market had clear limitations given the very different environment. Some pointed to the development of credit bureaus as helping risk assessment, but it was also observed that banks were reluctant to share data on borrowers with their competitors. Although there was wide agreement that external ratings can help risk management, it was also noted that it was realistic to expect external rating agencies to rate only a comparatively small proportion of the local companies. Some reliance on local credit rating agencies was therefore inevitable. Ways had to be found to guard against the risk of compromising objectivity and the lack of international comparability (all the more important as the banking industry becomes global). A second challenge was that the lack of standard VaR computations sometimes made it hard for supervisors to verify the risk management procedures banks had in place. Finally, several said that modern risk management techniques made formidable demands on staff, IT systems and budgets.

As financial systems have become more market-oriented, new risks have had to be addressed. Two such risks were mentioned - those related to liquidity and credit risk transfer.

Central banks in many jurisdictions have at some point sought to induce banks to rely on interbank markets, rather than on the central bank, for liquidity.¹⁰ Not all central banks have yet managed to make this transition. Imperfect information can inhibit the supply of credit from one bank to another. Still, a large central bank role in interbank markets has clear disadvantages: it nurtures the (perhaps erroneous) belief that the central bank stands ready to rescue weak banks - and this obviously creates moral hazard.

A high degree of concentration can distort the functioning of the interbank markets, and may make it less reliable in a crisis. For example, mechanisms to support the delivery of securities in repo transactions have proved in some cases to be uncertain. A lack of liquidity in interbank markets has at times also created difficulties. In one country, an anti-money laundering campaign unexpectedly resulted in the interruption of the flow of credit to the interbank market. The environment of low and declining interest rates and abundant liquidity that prevailed over much of 2002-05 naturally favours interbank markets. But this should not lead to complacency about how such markets might react if interest rates were to rise.

¹⁰ The function of the central bank as a lender of last resort raises, of course, different issues and has been left aside.

Risks related to credit risk transfer instruments have been extensively debated. Such instruments are attractive because they make financial markets more complete and so facilitate hedging. Both protection buyers and protection sellers gain. Banks can sell credit exposures arising from loans they originate. On the other side, investors buy such instruments to increase their exposure to high-yield paper (eg written against credit card debt, loans to small enterprises and so on) and such portfolios can be diversified to minimise risks. Such instruments can also serve to direct funding to certain priority sectors, such as the mortgage market, as well as being used to facilitate financial sector restructuring and the disposal of non-performing loans.

Despite the undoubted attraction of such instruments, several participants wondered whether their rapid spread was not outpacing the capacities of banks, non-banks and market structures to absorb and price risks efficiently. Are risks truly being transferred, or do certain clauses (or even a bank's reputation) mean that such risks could return in certain circumstances? Are transferred risks concentrated in a few players: if so, what are the implications? Are risks in effect being shifted from regulated entities such as banks to entities that are not regulated or are not regulated effectively? The backlog of confirmations of trades in wholesale markets, the fact that some contractual arrangements have not been tested in court, and a lack of supervisory expertise (in bank boards as well as in supervisory agencies) - all these elements suggest the need for caution.

4. Preventing systemic banking crises

There are several layers of public policies to reduce the risk of systemic crises: rules on corporate governance to ensure banks are well managed; disclosure requirements to help market players to actively monitor banks' changing risk exposures; prudential regulations and supervisory oversight; early corrective action when problems emerge; deposit insurance; and the lender of last resort function.

Greater consciousness of the importance of good corporate governance has led the authorities in many emerging market countries to take measures to ensure that their banks are better run and that their operations are more transparent. Many felt that having appropriate ownership structures was essential for nurturing good governance practices. The much greater attention paid by rating agencies to banks in emerging economies has produced a significant increase in publicly available assessments of the banks' health. Such assessments are both qualitative and quantitative. Some participants, however, said ratings should be treated with a degree of scepticism. It was noted that they were not updated frequently. Ratings improved only gradually even after radical improvements in a bank's underlying health.

On prudential regulation, the extension and deepening of international understandings as to what constitutes good supervision have affected supervisory regimes worldwide over the past decade or so. The 1988 Capital Accord marks the beginning of this process. Of particular importance for emerging economies have been the Core Principles for Effective Banking Supervision of 1997 and the Financial Sector Assessment Program (FSAP). The issuance of a new capital accord (Basel II) is expected to continue to nurture the development of a culture of risk management.

Capital ratios are of course key. It has often been said that capital ratios need to be higher in emerging economies because the macroeconomic environment is more unstable. Villar's paper therefore compares both capital ratios and macroeconomic volatility between the late 1990s and the first half of the 2000s. In the United States, there has been little change in either - risk-based capital ratios have risen only slightly and there is little discernible movement in volatility. The situation in Latin America and the crisis-hit countries of Asia, however, has been transformed. Macroeconomic volatility has fallen dramatically and risk-based capital ratios have risen. On this important reading alone, then, there is strong evidence that the systemic weaknesses of emerging market banking systems that were clear in the mid-1990s have been considerably reduced.

This reassuring picture is confirmed by the survey of supervisory practices more generally. Villar's paper documents steps taken to dilute risk concentrations and limit connected lending; to establish realistic provisioning rules; and to improve the inspection process. A common theme in the meeting discussion was the evolution in supervisory strategy from "ratio watching" (checking bank positions against predetermined prudential ratios) to a risk-based process (examining the bank's risk management process). But this evolution took time. Old mindsets had to be discarded - in supervisory

agencies as much as in the audit departments of banks. One participant noted that their new Examiners' Manual had been sent to bank audit departments in order to help improve risk management processes. Financial firms had to improve the quality and often increase the quantity of staff in risk control functions.

Outside assessments of the supervisory process doubtless helped. Several participants said that the FSAPs led by the IMF had been very helpful in this regard, but a number of supervisors also complained about their difficulties in attracting the high-calibre staff needed to conduct the supervisory process. In a competitive environment, many of them find it hard to keep and groom staff.

Recent crises have strongly reinforced the message that the authorities need to be able to take action quickly to deal with incipient problems before a full-blown systemic crisis develops. Confidence depends on all involved recognising that the authorities not only have such power but also have the right to use it speedily. Delay could be fatal. In many of the countries attending the meeting, much thought has been given to establishing arrangements that make early action more likely. Independence and legal protection for supervisors are one element. Increased transparency is another. One participant explained that the new Banking Act in his country allowed the minister of finance to take action (without parliamentary approval) if the central bank, the treasury and the supervisory authority all agreed that a systemic risk had arisen. This procedure avoided the difficulty of having to define a systemic crisis in abstract before the event.

There was general agreement that an explicit deposit insurance arrangement - subject to a ceiling and not applying to wholesale markets - could make credible the stance that the government did not guarantee all bank deposits. There was a general preference for premia that were fixed ex ante rather than levies imposed only after a crisis. Ex ante premia ensured that payments were made in good times (and so were not procyclical); created a fund that could be used to ensure prompt payouts; and meant that failed banks would have paid contributions. One speaker said that making banks contribute to a special fund to deal with failed banks was much better than relying on general fiscal sources because this would induce banks to monitor carefully the strictness and effectiveness of the supervisory authority. There was also some preference for charging risk-weighted premia; one scheme did not cover any deposits carrying an interest rate beyond a certain ceiling.

5. Implications for monetary policy

The relationship between the financial system and the workings of monetary policy is complex, and few simple or definite conclusions are possible. One view shared by many at the meeting was that monetary policy had become more potent in recent years as banking systems have become more deregulated and integrated globally. A wider range of transmission channels are now in play, including asset market and exchange rate channels. Views on the operation of the interest rate transmission channel varied. Archer's paper in this volume provides some evidence that domestic bank loan interest rates are more responsive to changes in money market rates in countries with profit-driven banks operating in competitive markets. But Archer also provides evidence that weakness in the banking system tends to reduce the pass-through of interest rate cuts. This appears to have happened in Asia after the 1997-98 crisis. Lower loan rates and the resurgence of bank credit growth in the past couple of years in countries which had had major banking crises in the second half of the 1990s are therefore further evidence that banking systems in emerging markets are indeed much healthier.

It was also clear from the discussions that external factors not related to monetary policy were important in shaping banks' behaviour. One participant noted that the demand for bank deposits depended on exchange rate expectations: this is presumably an important channel in countries where households and firms switch readily between local currency and foreign currency deposits. It was also noted that the global integration of capital markets had led to some convergence in long-term interest rates.

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