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Understanding the behavior of bank spreads in Latin America

Philip L. Brock [a,1], Liliana Rojas Suarez [b,*]

[a] *Department of Economics, University of Washington, Seattle, WA 98195 3330, USA*
[b] *Deutsche Bank Securities, 31 West Bank 52nd Street, 12th Floor, New York, NY 10019, USA*

Abstract

Over the last decade, many countries in Latin America have eliminated interest rate ceilings, reduced reserve requirements, and stopped direct credit controls. These market-oriented reforms have encouraged financial deepening, thereby producing considerable economic benefits to the countries. Nevertheless, the persistence of high interest rate spreads has been a disquieting outcome of the reforms. This paper explores the determinants of bank spreads in a systematic way for Argentina, Bolivia, Chile, Colombia, Mexico, Peru, and Uruguay during the mid-1990s. The analysis shows that high operating costs raise spreads as do high levels of non-performing loans, although the size of these effects differs across the countries. In addition, reserve requirements in a number of countries still act as a tax on banks that gets translated into a higher spread. Beyond bank specific variables, uncertainty in the macroeconomic environment facing banks appears to increase interest spreads. The combination of these microeconomic and macroeconomic factors is a cause for concern in Latin America. As spreads widen, the cost of using the financial system becomes prohibitive to some potential borrowers. In addition, the results suggest that bank capital requirements may not prevent excessive risk taking by banks when bank spreads are high.

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[*] Corresponding author.
E-mail addresses: plbrock@u.washington.edu (P.L. Brock), liliana.rojas-suarez@db.com (L. Rojas Suarez).
[1] Tel.: +1-206-543-5796; fax: 1-206-685-7477.

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1. Introduction

Over the last decade, Latin America has initiated a process of financial sector reforms. These reforms included, in almost all countries, liberalization of interest rates and elimination of mechanisms for direct allocation of credit. In some of these countries, reforms have gone well beyond the elimination of interest rate controls and have included an overhaul of the regulatory and supervisory systems for financial institutions. In many others, however, deficiencies in regulatory and supervisory standards remain. Notwithstanding the difference in degree of reforms, countries in the region have shown a commitment to continue the process, albeit at different paces.

The commitment to a market-oriented financial system has been tested twice during the 1990s. The first test occurred in 1995 when, following the Mexican financial turmoil, a number of banking crises erupted in the region. In sharp contrast to the early 1980s, when the policy response to banking crises in a number of countries in the region was to reintroduce interest rate and exchange controls and to increase the participation of governments in bank activities through nationalization, the policy response to the financial difficulties of the mid-1990s was an intensification of reforms and a further movement towards less direct government intervention.

The second test to the region's commitment to free financial markets took place beginning in mid-1997 with the eruption of the severe financial crisis in Asia. Improved economic fundamentals coupled with adequate policy response to the reduced availability of foreign financing allowed the region to weather the crisis during the first year. But as the Russian moratorium of mid-1998 exacerbated the international financial crisis, the sudden stop of short-term capital inflows to emerging markets exposed existing policy inconsistencies in a number of Latin American countries. This led to the eruption of exchange rate and/or banking crises in the region once again (Brazil, Ecuador, and Colombia).

In spite of the severity of recent events, however, the region has not gone back to the policy of interest rate controls. Instead, all indicators point toward a strengthening of the process of opening domestic financial markets. Indeed, there is a widespread recognition of the benefits of an increased participation of foreign banks in the domestic financial landscape.

But, while the process of financial market liberalization and integration is fully supported by policymakers in the region, there is a certain degree of disappointment with some of the results. In particular, policymakers expected that interest rate spreads — the difference between the interest rate charged to borrowers and the rate paid to depositors — would converge to international levels. Policymakers care about bank spreads because they reflect the cost of intermediation. In the absence of government intervention on banks' activities, high spreads are usually interpreted as an indicator of inefficiency, which adversely affects domestic real savings and investment. By increasing competition, it was expected that market