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Brazilian retail banking and the 2008 financial crisis: Were the government-controlled banks that important?

Claudiney M. Pereira^{a,*}, Luiz F. Maia-Filho^b

^a Tulane University, Department of Economics, New Orleans, LA 70118, USA

^b Univ. Federal Rural de Pernambuco, Departamento de Economia, Recife, PE 52171, Brazil

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ABSTRACT

We revisit the interest rate pass-through effect using weekly retail banking data from May 2006 to March 2010. Our choice of data avoids caveats of previous studies concerning excessive data aggregation and the estimation of how fast changes in benchmark interest rates impact those charged on short-term loans in Brazil. Our analysis focuses on four large retail banks – two of them privately owned and run, two of them government-controlled – before and after September 2008. They account for 60% of the total credit supplied by retail banks. Results indicate that government control over two of the largest banks, supposedly an asset for crisis management, may have had higher welfare costs than assumed. We find no evidence of asymmetry in adjustments of retail rates charged by private and government-controlled banks.

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1. Introduction

This paper aims to contribute to research on interest rate pass-through and monetary policy transmission in oligopolistic banking markets. These are critical issues from academic and policy standpoints, as revealed by a rapidly growing, rich, international literature.¹ Along with the analysis of a variety of relevant aspects, contributions typically apply econometric techniques to estimate how fast and thorough the adjustments of interest rates are to changes in base rates or money market rates, which are directly influenced by monetary authorities.

Espinosa-Vega and Rebucci (2003) applied a standard Error Correction Model to consider whether interest rate pass-through in Chile's recent experience was atypical compared to 10 other countries, including the United States. Indeed, the adjustment in the Chilean banking sector was incomplete – like in other countries – but generally faster than those in the rest of their sample. Also interesting was the fact that the adjustment process was affected

by institutional changes in the exchange rate regime and Chile's monetary policy targeting.

Hofmann and Mizen (2004) investigated 17 years of monthly data for rates on 13 deposit and mortgage products offered by UK financial institutions, considering potential non-linearity in adjustment of retail rates to base rates, due to menu costs. In their empirical exercise, the speed of adjustment responded nonlinearly to the expected size of the gap between the base and retail rates in the near future. In other words, the perceived (expected) “aggressiveness” in base rate management was a significant factor explaining the speed of pass-through effects.

Euro-area cross-country comparisons conducted by Sørensen and Werner (2006) raised empirical evidence of high-degree heterogeneity in pass-through of base rates to bank interest rates. Among other cyclical and structural factors, they found different degrees of competition in national banking sectors to be the most significant determinants of pass-through speed.

The focus of the present investigation is to address such issues for the Brazilian banking sector, a country with three well-known and somewhat unique characteristics:

- (i) Persistently, extraordinarily high interest rates on short term loans – in comparison to the ones observed in other emerging economies.

* Corresponding author. Tel.: +1 504 862 8351; fax: +1 504 865 5869.

E-mail addresses: cpereira@tulane.edu (C.M. Pereira), lui@dlch.ufpe.br (L.F. Maia-Filho).

¹ See Espinosa-Vega and Rebucci (2003), Hofmann and Mizen (2004), De Graeve et al. (2007), Leuvensteijn et al. (2008), Liu et al. (2008) and Coelho et al. (2010).

- (ii) Very high (and growing) market concentration, revealed by the participation rates of the four largest banks in total volume of credit operations and total assets.
- (iii) Significant participation of government-controlled public banks (GCBs, hereafter) in both volume of credit and assets.

A number of conjectural explanations for persistently high interest rates in Brazil have been statistically tested and not rejected; examples include extremely high reserve requirements to commercial banks (above 50% for checking accounts), heavy taxation on credit operations, high delinquency rates, political or institutional uncertainty, and lack of competition in the banking sector (World Bank, 2006).

The last conjecture listed above – lack of competition – was somewhat discredited, although not entirely dismissed, in studies published by policy researchers associated with the Brazilian Central Bank.² Tonooka and Koyama (2003) searched for but found no relationship between interest rates on loans and market concentration in the Brazilian banking sector. Alencar (2003) estimated the speed of pass-through effects from changes in benchmark interest rates and compared them to those observed in retail banking. Full response of monthly-average retail rates to changes in the opportunity cost of money, occurring over less than 12 months, was pointed out as evidence of a significant degree of competition, driving banks to operate efficiently.

During the financial crisis, the Brazilian government praised GCBs several times for playing an important role in stabilizing the economy and for helping achieve a faster pass-through from benchmark to retail rates. Indeed, Bernanke and Gertler (1995) found that the existence of a market imperfection increases the effectiveness of monetary policy. Recently, Coelho et al. (2010) found that the pass-through is higher for larger banks using a sample from June 2000 to December 2006.

In this paper, we revisit the pass-through effect in the Brazilian banking industry using data made available on a daily basis by the Brazilian Central Bank – compiled and assembled into a time series for this specific purpose. This high-frequency data set on rates charged by individual banks to businesses is informative about the pass-through effect in an oligopolistic credit market because the speed of adjustment can be estimated (and compared) for each of the four largest institutions – two of them privately owned and run, two GCBs. Over time, faster adjustments to changes in benchmark interest rates would be evidence of GCBs' role in strengthening the impact of monetary policy, under typical or exceptional circumstances.

Our main results indicate a larger pass-through after the financial crisis than before September 2008, but no asymmetric response from private banks and GCBs. GCBs were actually not responsive to changes in the benchmark interest rate before the financial crisis. The changing behavior of the GCBs after the financial crisis³ should be interpreted with caution, however, as there was a substantial increase in market concentration over the considered period.⁴

The remainder of the paper is structured as follows: Section 2 details our choice of data. Section 3 describes the econometric ap-

proach to calculate the pass-through. Section 4 presents our main results. Finally, Section 5 summarizes and concludes the paper.

2. Previous and current choice of data

Previous studies of the pass-through effect in Brazil were conducted on overall averages of interest rates in the banking sector, including multiple banks and different credit instruments – although broken into two debtor categories: personal/individual loans and businesses ones.⁵ Additionally, aggregation over time resulted in series of monthly data that can be considered inappropriate in this context: as one estimates how fast changes in benchmark interest rates impact the rates actually charged by banks on loans, the use of monthly averages will tend to “smooth out” immediate effects of monetary policy decisions on market operations. This is the case because both the length of intervals involved in Copom⁶ decisions and, consequently, the dates on which they occur only occasionally match starting or ending days of typical monthly averaging.

Our data set has the following characteristics:

- (i) *Bank level data*: by selecting the four largest retail banks in the country (two of them actually managed by executives appointed by the Federal Government), one can address the relative importance of the official credit policy for the evolution of retail rates charged by both GCBs and privately run banks. Banco do Brasil and Caixa Economica Federal (CEF) are the GCBs and Bradesco and Itau are the privately owned banks.
- (ii) *Weekly figures*: single observations of our series are volume-weighted averages of rates actually charged by a specific bank in a particular credit instrument, over a five-business-day interval – centered on Wednesdays, except when bank holidays coincide.

We chose four types of credit instruments⁷: discounted trade bills (*desconto de duplicatas, or simply Duplicata*), Corporate Overdraft Accounts (*Conta Garantida, or Garantida*), short-term working-capital loans (*Capital de Giro, or simply Giro*) and Personal Overdraft Account (*Cheque Especial, or Cheque*). All instruments have effective interest rates fixed at the contract signing.⁸ The option for mostly business loans (the first three cited above) is due to the fact that a dominating new personal credit instrument (*credito consignado*) was recently introduced, prompting a significant and ongoing individual portfolio rearrangement of personal liabilities. Additionally, payroll services contracted by medium-sized and large businesses tend to weaken individual efforts to search for better loans and, consequently, to migrate from one bank to another. Therefore, competition in that segment of the market is arguably limited. Nevertheless, we did include Personal Overdraft Accounts (*Cheque*) on recognition that, for a significant number of micro and small entrepreneurs, personal and business finances are continuously intertwined.

The benchmark interest rate in Brazil, known as Selic, is set at 45-day intervals by the Monetary Policy Committee (Copom) –

² Obviously, the authors explicitly stated that their findings and conclusions did not express the views of the Brazilian Central Bank.

³ We refer to the period from September 2008 to March 2010 as “post-crisis” or “after the financial crisis”; those expressions actually refer to the period after the Lehman Brothers bail out, arguably the very beginning of a more acute stage of the financial crisis. Despite the evident imprecision, we kept those expressions for the benefit of conciseness.

⁴ Numbers from the Brazilian Central Bank website indicate that the share of the four largest banks in total assets increased from 45% in 2006 to 61% in 2009. See <http://www.bcb.gov.br/?ENGLISH>.

⁵ A couple of very recent exceptions must be mentioned: Castro and Mello (2010) used disaggregated data to study the interest rate pass-through in personal loans; Coelho et al. (2010) also used daily bank-level information of volumes and rates charged on credit operations – data not publicly available for bank privacy reasons.

⁶ Copom is the Brazilian Monetary Policy Committee, the executive organ of the country's Inflation Targeting System.

⁷ CEF, one of the GCBs considered, does not offer Corporate Overdraft Accounts (*Garantida*).

⁸ Due to the historically high volatility of benchmark interest rates (“Selic”) in Brazil, a significant part of loans and long term deposits pay returns in accordance with “Selic” at maturity. These are generally called post-fixed rates.

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