Summary and Conclusions

✠ The previous Financial Stability Report showed that solvency had improved not only for credit establishments but also for firms and households, which are the system's main counterparts within the real sector. Specifically, the Report described how the financial system's solvency had recovered and its main clients' financial situations had returned to normal. In this context, institutional conditions were ripe for intensifying credit relations between the financial system and the real sector.

✠ Thus, credit rebounded strongly in the last quarter of 2002 and early 2003.

✠ It is noteworthy that the credit upturn has gone hand in hand with continued improvement in balance-sheet quality for the financial system and its private clients.

✠ The following paragraphs outline the features of the macroeconomic setting most affecting the financial system, the main developments and risks of the system's major clients and its balance-sheet trends and risks.

Macroeconomic Developments

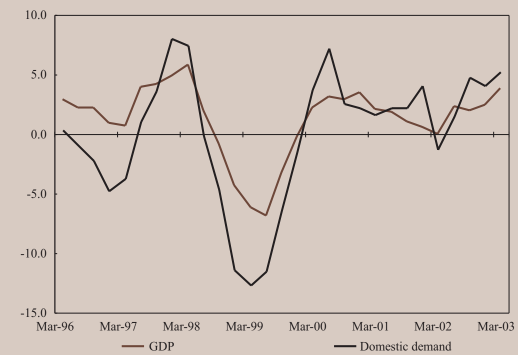
✠ Internationally, the most striking development in recent months has been a better perception of the region at a time when the world economy has weakened. Although the developed economies' poor performance has had a negative impact on Latin American exports, their low interest rates are an advantage to the region's countries for attracting capital flows. The region has also benefited from greater clarity about Brazil's management of economic policy. As a result, Colombia and its neighboring countries now have better prospects of access to sources of external financing (Figure 1). This is a positive development, for in recent years the external environment has been a major determinant of stability in domestic financial markets.

✠ Domestic spending, which affects the nontradables sectors' demand for credit and ability to pay, rose sharply in the second quarter of last year and the first months of this year. As shown by

Figure 1
Embi Plus Spread for Colombia
(Basis Points)

Source: Bloomberg.

Figure 2
Real GDP and Domestic Demand Growth
March 1996-March 2003
(Percentage)



Source: DANE (State Statistical Agency).

Figure 2, domestic demand has grown faster than GDP in recent months. Higher domestic demand has resulted largely from the favorable environment, which has raised confidence, allowing interest rates to be kept low and stable. It has also been boosted by rising urban employment, which increases aggregate consumption. There is currently no reason to expect a reversal of this demand behavior in the near future.

✠ On the fiscal front, the financial system's exposure to public debt has been reduced but it is still high, and financial stability will depend greatly on what happens in this respect. Although market perception of the government's debt has improved, the process of fiscal adjustment must continue in order for this perception to become enhanced.

✠ Lastly, external demand deteriorated in 2002 and over the first quarter of this year, affecting most exports. It is not clear from available figures whether this trend has impaired the performance of companies producing tradable goods, but if it persists the financial system may face risks from these companies' exposure.

Major Debtors' Recent Behavior and the System's Risk Exposure

Private corporate sector

✠ The financial system's exposure to the private corporate sector increased over 2002 and first quarter of 2003, after systematically decreasing from 1997 to 2001.

✠ The increase in the private loan portfolio has coincided with improvement in its quality. The financial system may therefore be expected to show greater readiness to lend in the near future.

- The private sector's economic performance outlook has improved systematically, suggesting that demand for credit may continue to rise in the short term.

- The findings from the sample of companies reporting to the Securities Superintendency are consistent with greater corporate ability to pay. Profitability and liquidity indicators have improved systematically.

- The levels of both financial pressure and borrowing have risen, largely because of the effect of devaluation, suggesting greater exchange-rate exposure. But two points need to be made clear: first, the external borrowing behavior of the private sector as a whole is not consistent with the sample group's; second, in the past six months the sample companies have partly hedged against this risk through foreign-currency investments. On the information available, however, it is not possible to quantify net exposure.

Households

- The financial system's exposure to households has remained relatively steady in the past year, as evidenced by the stocks of loans extended to them and their share of the financial system's total assets. Strong growth in consumer loans has coincided with poor expansion in mortgage loans, with the result that, as lenders to households, banks specializing in mortgage loans have lost share to commercial banks and commercial financing firms.

- The quality of household debt has continued to improve, prolonging the trend begun at the end of 2000. Some factors that might account for this improvement are: positive wage-income developments in the second half of 2002 and first quarter of 2003, employment recovery in April and May 2003, and an upturn in house prices since January.

- Yet, judging by the consumer confidence index, the outlook for household borrowing is still not clear. For there is no definite tendency to purchase such goods as real estate that are usually financed with credit, though some advance was observed in April and May 2003.

Nonfinancial public sector

- The financial system's direct exposure to public debt decreased between December 2001 and March 2003, reversing the rising trend started in the mid-1990s. This behavior was common to both commercial banks and banks specializing in mortgage loans.

- The recent improvement in the financial conditions of public debt is a positive development. Market perception of the government's solvency has also improved; this is reflected in lower spreads on external public debt and lower rates on domestic public debt, improving the financial entities' results relative to the previous Report.

✠ Though the total stock of nonfinancial public-sector debt continued to rise in the first quarter of 2003, it did so at a slower pace. This behavior is largely attributable to the central government, which is still the biggest debtor in the public sector.

✠ The risk to the financial system from public-sector debt would therefore appear to have decreased in recent months. It remains to be seen how the placement of nonfinancial public-sector debt securities will develop in the coming months. According to the government's domestic financing needs, the above trend may reverse.

✠ Subnational debt declined over 2002 and the first three months of 2003. Exposure has generally been moderate, and debt quality has improved. The Cauca Valley Department's indebtedness is still the biggest risk, despite a pick-up in its revenues/debt ratio.

Recent Financial-System Developments

✠ The financial sector's credit portfolio has begun to show high growth rates not seen since the 1998-1999 crisis. The upturn in credit is more clearly evident in microcredits, consumer loans and commercial loans.

✠ Investments held by the financial sector have recovered strongly from the episode of TES-market stress in July and August 2002. Much of this recovery has come from the purchase of mortgage securities created by home-loan securitizations and a pick-up in TES prices.

✠ The rally in profitability described in the previous Report has gathered pace in recent months, so that the system's profitability is now consistent with periods of relative financial stability. Substantial differences exist however between the performances of Colombian and foreign entities, with the latter's earnings indicators running below the system average. Up to the end of 2002 much of the difference was attributable to foreign banks' more conservative approach to allocating assets, which resulted in lower earnings.

✠ Likewise, credit-risk indicators continued the downward trend displayed last year. In effect, the proportion of overdue balance to gross balance fell to its lowest level since 1998 for all types of credit except home loans, which continued to register a high proportion of overdue balance. As regards portfolio coverage against credit risk, current provision levels furnish historically high coverage, reducing credit establishments' vulnerability in situations where credit risk materializes.

✠ It is of crucial importance to the system that appropriate portfolio allocation be maintained. Hence, new credit allocations in particular will need to be monitored, with special attention to segments presenting high growth in portfolio stock.

- All liquidity indicators have registered satisfactory levels this year despite portfolio expansion, which suggests that the financial system should have no liquidity problems in the short term.

- Trends are currently beginning to emerge that may affect liquidity in the medium term. Faster credit expansion and the central government's domestic financing needs will require strong deposit growth by the medium term, probably stronger than the growth observed up to May, because otherwise structural liquidity pressures might arise. Such pressures in turn would be reduced to the extent that the incipient inflow of capital and transfers observed in May and June continues.

- Given the foregoing, greater buoyancy in credit may be said to have resulted from a strengthening of various factors of supply as well as demand. On the one hand, high liquidity levels together with low credit risk and adequate capital levels have boosted the supply of credit. On the other hand, the incipient economic upturn associated with higher future expectations, particularly among firms, has pushed up demand. It is to be noted that such a combination of factors so favorable to credit expansion has not occurred since before the crisis of 1998-1999.

Board of Directors, Banco de la República