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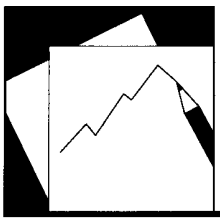

IMF Working Paper

The Determinants of Banks' Liquidity Buffers in Central America

Corinne Deléchat, Camila Henao, Priscilla Muthoora,

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Prepared by Corinne Deléchat, Camila Henao, Priscilla Muthoora, Svetlana Vtyurina[1]

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December 2012

Abstract

Banks' liquidity holdings are comfortably above legal or prudential requirements in most Central American countries. While good for financial stability, high systemic liquidity may nonetheless hinder monetary policy transmission and financial markets development. Using a panel of about 100 commercial banks from the region, we find that the demand for precautionary liquidity buffers is associated with measures of bank size, profitability, capitalization, and financial development. Deposit dollarization is also associated with higher liquidity, reinforcing the monetary policy and market development challenges in highly dollarized economies. Improvements in supervision and measures to promote dedollarization, including developing local currency capital markets, would help enhance financial systems' efficiency and promote intermediation in the region.

JEL Classification Numbers: E44, G21, O16

Keywords: Central America, bank liquidity, credit, dollarization, excess liquidity, foreign banks

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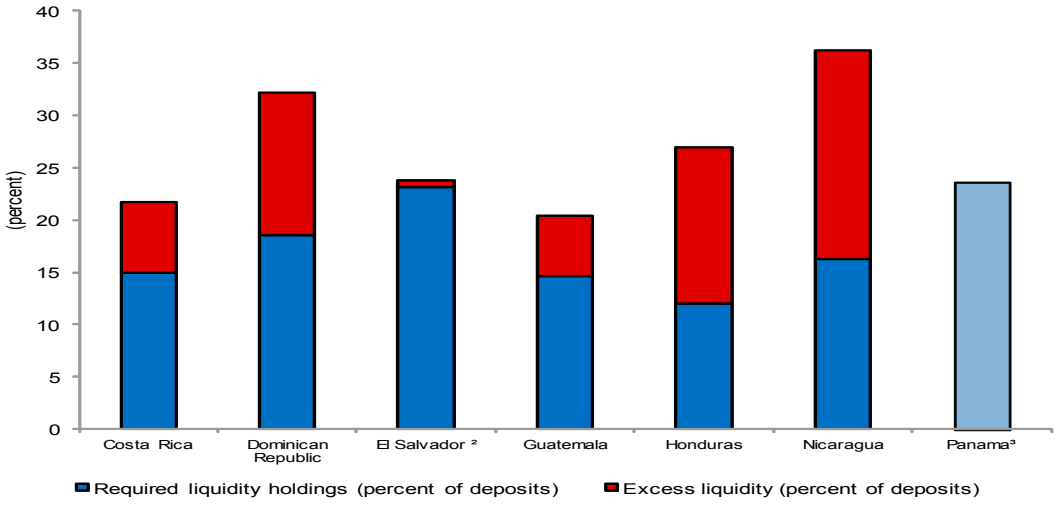
I. INTRODUCTION

This paper studies the determinants of banks' liquidity buffers in Central America, [1] Panama and the Dominican Republic (CAPDR) using a panel of about 100 commercial banks over 2006-10. In particular, the paper examines whether CAPDR banks' liquidity buffers, defined as the liquid assets to deposits ratio, can be explained by bank and country-level characteristics, as predicted by theory and documented in some empirical studies. Of particular interest for the region is whether liquidity holdings are related to bank ownership (are public or foreign banks different?) or the economy's degree of dollarization.

CAPDR banking systems are highly liquid. Holdings of liquid assets as a share of total deposits averaged about 28 percent for the region in 2010, while reserve requirements were set at about 17 percent on average (Figure 1). Liquidity ratios are also high compared to larger South-American countries; liquidity ratios averaged about 15 percent for Brazil, Chile and Colombia in 2010. For monetary and supervisory authorities, ensuring that banks hold adequate amounts of high-quality liquid assets is essential for financial stability, as highlighted during the recent global financial crisis. However, if liquidity holdings are much above legal requirements, this may be costly in terms of foregone financial intermediation. Excess liquidity also hinders the development of interbank and money markets in all countries, and acts as "sand in the wheels" of the monetary transmission mechanism in countries with a monetary policy (Gray, 2011).

Figure 1. CAPDR Liquidity Buffers[1] (2010)



Sources: CAPDR Central Banks and Superintendencies' websites; and Fund staff calculations.

¹ Liquid assets to deposits ratio. Liquid assets include cash, central bank reserves and deposits abroad.

² Liquidity requirements.

³ Observed liquidity. Legal liquidity requirement (30%) is calculated as the ratio of liquid assets including securities to short term deposits.

[1] Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.

From individual banks' point of view, holding sufficient liquidity is necessary to insure against liquidity risk (Diamond and Dybvig, 1983, Diamong and Rajan, 2001). As loans are relatively illiquid, large and unexpected deposit withdrawals can lead to insolvency as it may be too costly or not possible to raise liquidity on short notice, due to capital market imperfections. Instead of self-insuring, banks could resort to other forms of financing, such as accessing interbank markets, central bank liquidity windows, or external credit lines. However, asymmetric information may lead to coordination failures on the interbank market, and external credit lines may freeze (as seen during the recent financial crisis), so that solvent but illiquid banks would still fail, absent a Lender of Last Resort (LOLR) (Rochet and Vives, 2004). Thus banks hold a buffer of liquid assets as self-insurance, equating the marginal benefit of holding liquid assets to the marginal cost of alternative investments.

A priori, one would expect the self-insurance motive to be especially important in CAPDR. Capital markets are underdeveloped, interbank markets are thin, and LOLR arrangements remain limited or nonexistent. For the five partially dollarized economies, the high share of foreign currency assets and liabilities limits the ability of the central bank to act as a LOLR, while the two fully dollarized economies in the region, Panama and El Salvador, did not have a LOLR as of end-2010 (El Salvador formally approved the regulations to establish a liquidity facility in June 2012). Furthermore, while the region's predominant reliance on customer deposits is a likely reason for its resilience during the global financial crisis, it is also a potential source of vulnerability and calls for the holding of adequate liquidity buffers.

In line with theory and results from related empirical studies, we find that CAPDR banks' liquidity buffers are persistent, consistent with the notion that banks target an optimal amount of liquid asset coverage of deposits or total assets. Liquidity ratios depend on idiosyncratic factors such as bank size, profitability, and efficiency. Measures of financial development also matter. We find some evidence that foreign banks in the region tend to hold less liquidity than domestic banks, possibly reflecting their access to more diversified funding sources or less risky business models. Furthermore, we uncover a robust positive impact of the degree of deposit dollarization on the size of liquidity buffers. This suggests that not only deposit dollarization in itself,[2] but also its association with higher liquidity holdings, contributes to weaken the monetary transmission mechanism in partially dollarized economies and hinders the development of money and interbank markets.

The reminder of the paper is structured as follows. Section II briefly reviews the theoretical and empirical literature on the determinants of liquidity holdings. Section III provides some background information on CAPDR banking systems. Section IV describes the data and presents stylized facts on the distribution of banks' liquidity holdings. Section V discusses the econometric methodology and estimation results, and Section VI concludes.

[2] See Medina Cas, Carrion and Frantischek, 2011a.

II. Determinants of Banks' Liquidity Buffers: Literature Review

The determinants of banks' liquidity buffers, as identified in the theoretical and empirical literature, can be classified into four broad categories. These are the opportunity costs of and shocks to funding, bank characteristics, macroeconomic fundamentals, and moral hazard motives, as discussed below.

Opportunity cost and shocks to funding

The early literature on bank liquidity uses the firm's theory of inventory decisions as a starting point. The cost of holding liquid assets (with low returns compared with other types of investments) is compared to the benefits of reducing risks of "running out" (Baltensperger, 1980, and Santomero, 1984). These models predict that the size of liquidity buffers should reflect the opportunity cost of holding liquid assets rather than loans. It should also relate to the distribution of liquidity shocks that the bank may face, and in particular be positively related to the volatility of the funding basis as well as the cost of raising additional funds.

Using aggregate time-series data for Thailand, Agénor, Aizenmann and Hoffmaister (2000) find that banks' demand for precautionary reserves (measured as the log of excess reserves over total deposits), is positively related to the penalty rate, proxied by either the discount or the money market rate, as well as to the volatility of the cash to deposit ratio. Dinger (2009) finds in a panel of Eastern European banks that liquidity buffers are negatively related to the real deposit rate but positively related to the interbank rate.

Bank characteristics

The newer generation of models explaining firms' (including banks') liquidity demand relies on some form of market imperfection to explain why banks cannot raise instantaneous and unlimited amounts of liquidity (financial frictions). The market imperfection is asymmetric information, either in the form of moral hazard (Holmstrom and Tirole, 1998) or adverse selection (Kiyotaki and Moore, 2008). Financially constrained banks would thus tend to hold more liquidity.[3,4]

Based on these models, bank characteristics affecting their ability to raise non-deposit forms of finance, such as bank size (small banks have more difficulties in accessing capital markets), profitability (more profitable banks can more readily raise capital and are thus less

[3] Holmstrom and Tirole (1998) and Kiyotaki and Moore (2008) make this argument for firms in general: Liquidity constraints, together with liquidity shocks, result in entrepreneurs not being able to raise the entire cost of their desired investment externally, so that they have to hold enough liquid assets to make a down payment for each unit of investment (there are also limits on the amount of equity that can be resold). This explains why, although the rate of return on cash is very low, entrepreneurs will choose to hold some in their portfolio. Liquidity shocks reduce the price of equity and increase the desired holdings of liquid assets.

[4] See for example Almeida, Campello and Weisbach, 2004, Kashyap, Rajan and Stein (2002), Kashyap and Stein (1997), Repullo (2003), and Rochet and Vives (2004).

liquidity constrained), ownership (both public banks and foreign banks should be less liquidity-constrained than private and domestic banks, respectively, as public banks may have an implicit guarantee and foreign banks would have access to support from headquarters)[5] would affect banks' precautionary demand for liquidity buffers.

Aspachs, Nier and Tiesset (2005) find that banks' liquidity buffers are related to bank characteristics such as loan growth and the net interest margin, with the coefficients on size and profitability being not significant. Kashyap and Stein (1997) and Kashyap, Rajan and Stein (2002), using a large panel of U.S. banks, find a strong effect of bank size on holdings of liquid assets, with smaller banks being more liquid as they face constraints in accessing capital markets. Dinger (2009) also finds that smaller Eastern European banks hold more liquidity, but with nonlinearities, and that foreign banks hold less liquidity.

Bank ownership may not only exert a direct influence on liquidity holdings, but may also affect the regression slope through interactions with other explanatory variables. In particular, Aspach, Nier and Thiesset (2005) find that, for the UK, foreign banks' liquid asset holdings are not affected by the availability of a domestic lender of last resort, while local banks are. Furthermore, in their sample foreign banks' liquidity holdings tend to react less to changes in the domestic policy rate and GDP growth, suggesting overall that they are subject to a somewhat different set of constraints than their local counterparts.

Macroeconomic fundamentals

The models mentioned above also have implications for the cyclical behavior of liquidity demand. If capital markets are imperfect, the demand for liquidity should be countercyclical, as banks would hoard liquid assets during recessions and offload them in good times given more opportunities to lend. This suggests that liquidity buffers would be negatively related to measures of the output gap or real GDP growth, credit cycle, and policy interest rates.[6]

The counter-cyclicality of liquidity buffers limits the effectiveness of monetary policy in trying to inject liquidity to stimulate the economy in a recession: liquidity buffers would remain stable or increase but credit would not necessarily pick-up. Moreover, financial frictions in terms of capital market imperfections should be expected to vary with structural factors such as the degree of financial development and the quality of financial institutions.

Aspach, Nier and Tiesset (2005) find that UK banks' liquidity buffers are negatively related to real GDP growth and the policy rate. Agénor, Aizenmann and Hoffmaister (2000) and Saxegaard (2006) find that excess reserves are negatively related to the output gap and the policy rate in Thailand and in sub-Saharan Africa, respectively. Dinger (2009) finds that liquidity holdings are negatively related to real GDP growth and real per capita GDP.

---

[5] Freixas and Holthausen (2005).

[6] Almeida, Campello and Weisbach (2004) develop and estimate on a large sample of U.S. manufacturing firms a model where financially constrained firms have a higher propensity to save cash out of cash flows.

Moral hazard and safety nets

In theory, the strength of the financial safety net and in particular the availability of a LOLR arrangement, should reduce the banks' incentives to hold liquidity buffers (Repullo, 2003). Empirical studies of UK and Argentinian banks, where LOLR support is measured as the Fitch support rating and the availability of external credit lines in the context of the currency board, respectively, support this prediction (Aspach, Nier and Thiesset, 2005, and Gonzalez-Eiras, 2003).

Dollarization or credit and/or deposits reduces the effectiveness of the domestic LOLR, as partially dollarized economies are subject to currency and liquidity risk, but the central bank cannot issue foreign currency (Gulde et al., 2004 and Levy-Yeyati and Broda, 2002). One would thus expect banks to hold higher liquidity buffers, the higher the degree of deposit dollarization, though the incentives to hold such buffers would diminish in the presence of a large stock of central bank international reserves or external credit lines, as these would be a ready source of dollar liquidity in the case of a run on dollar deposits (Ize, Kiguel and Levy-Yeyati, 2005). Using a sample of about 100 countries, De Nicoló, Honohan and Ize (2005) find that deposit dollarization is associated with higher solvency and liquidity risk measured by deposit volatility. To our knowledge no empirical study has focused on the effects of deposit dollarization on banks' liquidity.

III. Some Background on CAPDR Banking Systems

As a group of small open economies with strong linkages to the U.S. economy and various levels of dollarization, most countries maintain fairly stable *de facto* exchange rates against the U.S. dollar—although their formal monetary and exchange arrangements are quite heterogeneous. Two economies (Panama and El Salvador) are fully dollarized, three countries (Costa-Rica, Dominican Republic and Guatemala) have recently adopted or are moving toward inflation targeting, and Honduras and Nicaragua maintain crawling or tightly managed pegs.[7] The monetary policy frameworks in the five partially dollarized economies rely on rules-based instruments such as standing facilities and reserve requirements, with only partial money market operations, and all but Nicaragua have a monetary policy interest rate (Medina Cas, Carrion-Menendez and Frantischek, 2011b).

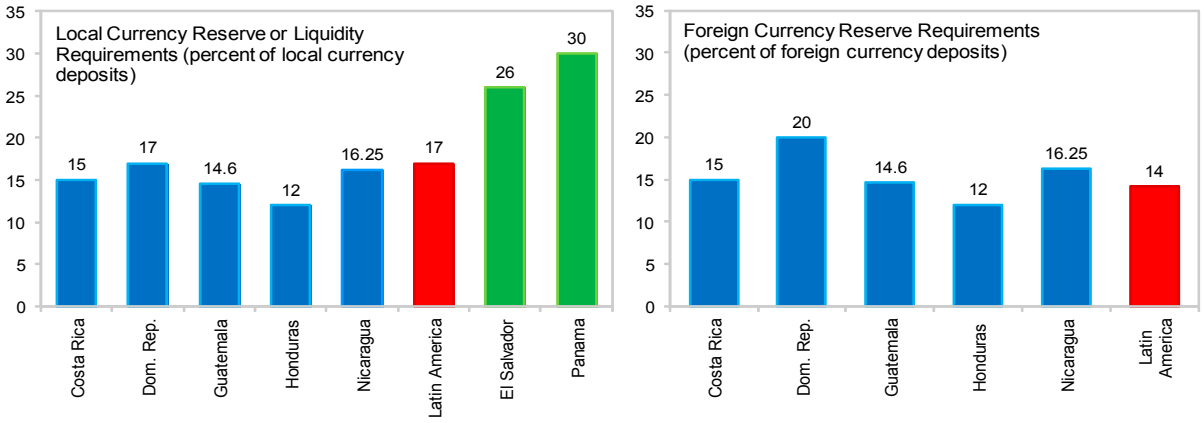
Reserve requirements in CAPDR are in line with those of the Latin America region, and average about 15 percent for local currency deposits and 15.5 percent for foreign currency ones (Appendix I, Table 1 and Figure 2) . The two officially dollarized economies rely on prudential liquidity requirements, held at the central bank in the case of El Salvador and by individual banks in the case of Panama (Appendix I).[8] Although they are potentially useful

[7] Costa Rica maintains a managed exchange rate regime with pre-defined bands for intervention but a substantial margin to fluctuate within the bands. Nonetheless, since December 2010 the exchange rate has remained within 3 percent of the floor of the band.

[8] Honduras also imposes specific liquidity requirements to avoid maturity mismatches (Appendix I).

policy instruments, reserve/liquidity requirements are not actively managed in most countries, with the exception of El Salvador and Honduras (Appendix I, Table 2).[9]

Figure 2. CAPDR: Statutory Reserves and Liquidity Requirements by Currency



Source: Central Banks and Superindendencies.
Note: Reserve requirements for all countries excluding Panama and Salvador (liquidity requirements). Liquidity requirement for Panama is defined as the ratio of liquid assets including securities and obligations payable to banks within 186 days, as a share of short-term deposits.

With the exception of Panama, the region's banking systems are relatively small, highly concentrated and dollarized to various degrees (Table 1). Panama stands out of the group in terms of the size of the system, which is four times greater than the sample average in terms of assets to GDP (Panama's offshore banks' assets represented only 50 percent of GDP at end-2010). In four countries (Honduras, Nicaragua, El Salvador and Panama) the share of foreign bank assets in total assets is more than 50 percent suggesting higher potential vulnerabilities from cross border linkages. While the presence of state banks is quite small in terms of number of banks and share of system's assets for the whole sample, state banks have a very strong presence in Costa Rica, with their assets accounting for 55 percent of total assets and 60 percent of deposits. Customer deposits are the main source of funding and show a high degree of dollarization, particularly in Nicaragua and Costa Rica. The share of short-term deposits is also relatively high in the region, although not in Panama.

[9] Given this, excess liquidity is probably best analyzed in the context of single country time-series studies. In the panel context, our preferred definition of liquidity buffers for the empirical analysis in section IV.C is the liquid assets to deposit ratio. The liquid assets to total assets ratio is used for robustness checks.

Table 1. CAPDR: Banking System Indicators, 2010

(in percent, unless otherwise indicated)

	Number of banks [5]	Number of State banks [2]	State bank assests in total assets	Number of foreign banks [3]	Foreign bank assets in total assets	Percent of assets in 5 largest banks	Assets to GDP	Credit to GDP	Assets in foreign currency in total assets	Credit in foreign currency in total credit	Deposits in foreign currency in total deposits	Demand deposits in total deposits
Costa Rica	16	3	55	9	26	78	60	46	46	47	41	53
Guatemala	18	1	2	7	13	79	44	30	23	30	24	41
Honduras	17	1	1	9	50	75	68	50	24	28	30	22
Nicaragua	6	1	0.01	4	67	97	62	34	72	90	73	31
Dominican Republic	15	2	31	4	29	87	32	18	26	21	30	18
El Salvador [1]	12	2	6	10	83	85	61	40	...	...	...	26
Panama [1, 4]	49	2	14	28	57	57	200	91	...	...	...	15

Source: Central American Monetary Council (SECMCA), International Financial Statistics, IMF staff calculations.

[1] Officially dollarized economies. [2] State share of more than 50 percent. [3] Banks with 50 percent of capital in foreign hands, excludes offshore.

[4] Domestic banking system; [5] April 2011.

Recent Financial Sector Assessments indicate that, overall, banking sectors in the region are well-capitalized, liquid and profitable (Figure 3). Financial systems remained resilient in the face of the 2009 global financial crisis mostly due to their strong initial positions. Despite rapid credit growth, the region did not experience any excessive credit booms and there was very limited exposure to toxic asset-backed securities, as well as to wholesale funding. Stress tests of liquidity risk suggested that banks had adequate coverage of their liquid liabilities, and could withstand deposit withdrawal shocks of 15–20 percent during a 30 day period. However, although banking supervision has improved over the past decade, compliance with Basel Core Principles remains uneven and below that of LA6. Financial safety nets remain incomplete, and financial markets are underdeveloped, including interbank markets (Box 1).

Box 1. Financial Systems Supervision and Development in CAPDR

Despite substantial progress over the past decade, financial supervision in CAPDR lags behind, both compared to larger emerging countries in Latin America and international best practices. Following a string of banking crises in the 1990s - Costa Rica (1987-91, 1994-95), El Salvador (1989-90), Nicaragua (1990-93), and Panama (1988-89) ,1/ a system-wide banking crisis in the Dominican Republic (2003-04), and the failure a large and a medium-sized bank in Guatemala (2006-07), the Central American countries strived to strengthen their supervisory frameworks. By 2010, CAPDR complied with more than half of the Basel Core Principles, though the performance was uneven across the region, with Panama showing the highest compliance and Costa Rica the lowest. The strengthening of financial supervision during the last decade has been relatively homogeneous between categories, but unequal by category within each country. The weakest areas in the region are risk-based supervision, cross-border consolidated supervision, and the fact that nonbank institutions frequently are outside the supervisory perimeter (Delgado and Meza, 2011).

Financial safety nets remain incomplete. All countries, except Panama and El Salvador, have a LOLR (though El Salvador is in the process of formally implementing one), and deposit insurance schemes are in place in all but two countries (Costa Rica and Panama). Weaknesses in most countries are observed in providing legal protection to supervisors and regulating systemic risk.

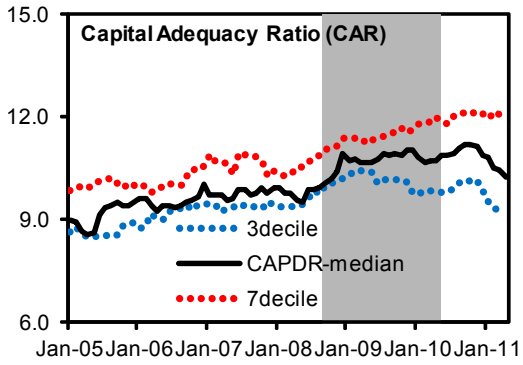
The region's money and capital markets remain underdeveloped.2/ Interbank markets are thin, segmented, and often lack proper collateral. Despite the high level of liquidity in the banking sector, the absence of collateral in inter-bank transactions increases systemic vulnerability to bank failures. A lack of active repo operations also stalls the standardization of transactions in the interbank market (see FSSAs for the region). The number of equity and corporate bond listings are generally in the single digits and market-capitalization-to-GDP ratios are quite low. Due to legal and other obstacles, institutional investors intermediate a relatively small share of national savings. Thus, the principal investors in government securities are commercial banks and public sector entities such as pension or social security funds. Secondary public debt markets are shallow as government securities are mostly held to maturity.

1/ Panama did not experience a typical banking crisis as the closure of the banking system for several months was due to the invasion of the country by the U.S. armed forces confronting the Noriega regime. There was no deposit runs prior or after the closure of the banks and there were no bank failures. However, this contributed to a significant output loss, estimated by some at 85 percent (Laeven and Valencia (2012)).

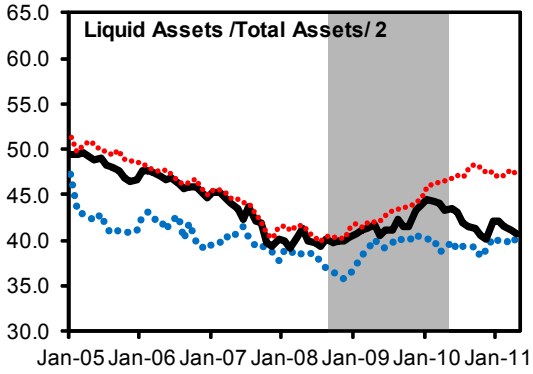
2/ See Shah et al. (2007a), and Shah et al. (2007b).

Figure 3. CAPDR: Financial Soundness Indicators, 2005-11/1

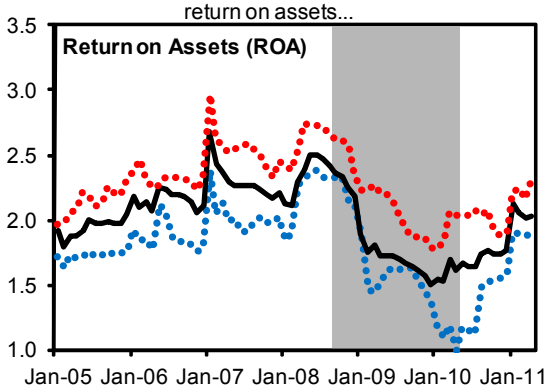
Despite the global crisis, risk-adjusted capital ratios remain adequate...



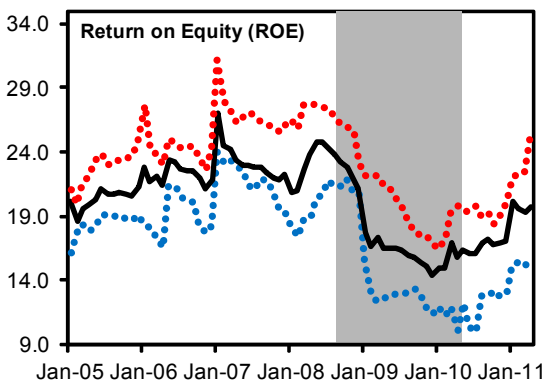
..and by 2010 banks had rebuilt their liquidity



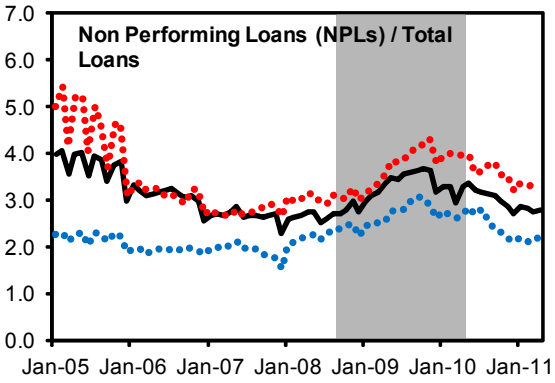
Bank profitability declined in 2008, with falls in the return on assets...



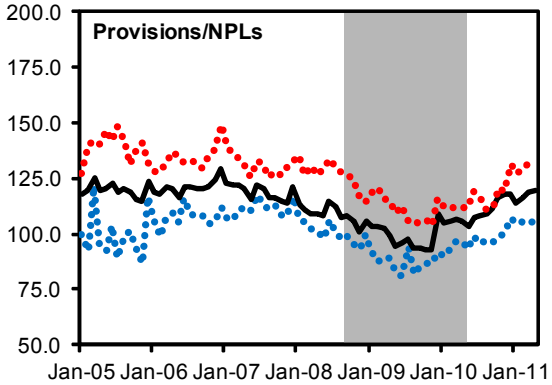
and return on equity, reflecting in part...



... a deterioration in the quality of loan portfolios.



Provisioning has generally lagged the growth in NPLs, but there are signs of recovery.



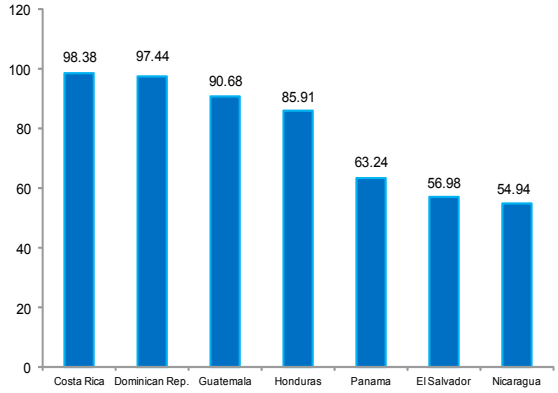
Source: Central American Monetary Council (SECMCA).
1/ Shaded area represents the 2008-09 global financial crisis.
2/ Liquid assets include short term investments.

IV. Determinants of Banks Liquidity Buffers in CAPDR

A. Data and Variable Definitions

Our sample combines annual data for 96 CAPDR banks over 2006–10 from the BankScope data base,[10] with country-level macroeconomic fundamentals and structural variables drawn from regional monetary and supervisory authorities' websites and other publicly-available databases as described in Table 2 below and Appendix III, Table 1. It covers 72 percent of all commercial banks in the region and about 80 percent of total banking system assets, though admittedly the coverage is not homogeneous across all countries in the region (Figure 4).[11]

Figure 4. Bankscope Sample Coverage of Total Banking System's Assets (2006-10 average, in percent)

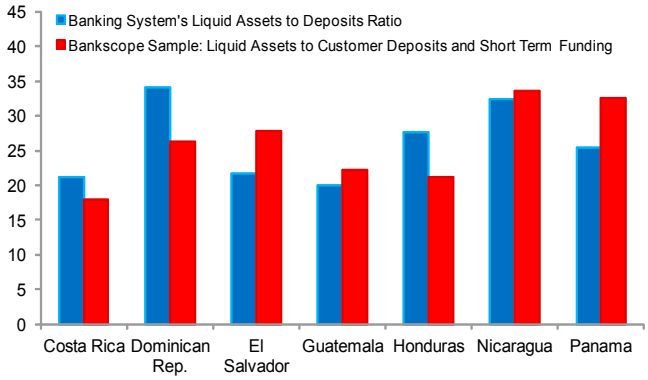


Source: BankScope database, CAPDR Central Banks and Superintendencies' websites, IMF staff calculations.

Definition of liquidity buffers

Liquidity buffers are measured by the ratio of liquid assets to customer deposits and short-term funding. Liquid assets include cash and cash-like assets, quoted or listed government bonds, and short-term claims on other banks. Although the breakdown of the numerator components is not available, there are relatively few listed government securities in the region (Shah et al., 2007b). The denominator includes banks' customer deposits and short-term interbank deposits. Customer deposits are the main source of funding in the region, with very low reliance on short-term funding (the share of customer deposits in the denominator is 93 percent for the whole sample). Overall, the ratio of liquid assets to customer deposits and short-term funding is close to system-wide liquidity ratios, defined as liquid assets (cash and

Figure 5. Liquidity Ratios at the System Level and in the Bankscope Sample (2006-10 average, in percent)



Source: BankScope database, CAPDR Central Banks and Superintendencies' websites; IMF staff calculations.

[10] A financial database supplied by Bureau van Djik.

[11] The information on coverage averaged over banks/years. A caveat is that missing institutions may not be random. The time period is restricted to the interval for which data for most CAPDR banks were available.

cash-like, excluding securities) to deposits (Figure 5). We use it as our main dependent variable, and use the ratio of liquid assets to total assets for robustness checks.[12]

Choice of explanatory variables

Opportunity cost, liquidity shocks and bank characteristics

We use the spread between the lending and the deposit rate as a measure of the opportunity cost. The probability of a liquidity shock can be proxied by a measure of the volatility of total deposits at the system level (we can calculate a monthly coefficient of variation of total deposits for each country, but have only annual bank-level data), or by the volatility of inflation. Past liquidity shocks may also matter: a history of banking crisis could lead banks to become more risk-averse and hold more liquidity.

Given the importance of public and foreign banks in Central America's banking systems, we are particularly interested in testing whether liquidity buffers vary systematically according to bank ownership (public/private and foreign/domestic).

We control for other bank characteristics such as size, measured as the log of total assets. The squared value of this variable captures possible non-linearities in the impact of bank size on liquid asset holdings (Dinger, 2009). Capitalization is measured as the ratio of equity to total assets. Profitability is measured by the ratio of the net interest margin to interest-earning assets. The loan-loss reserves to gross loans ratio should capture the banks' degree of risk aversion or perceived riskiness of the loan portfolio.

Macroeconomic fundamentals

We use output growth in CAPDR to capture the economic cycle. Financial development is captured by private sector credit to GDP ratio, a traditional proxy for financial depth. We also construct a quality of credit institutions index which combines four variables from the World Bank's Doing Business database [13] focused on credit and legal rights, ―strength of legal rights index (0-10); depth of credit information index (0-6); private bureau coverage (percent of adults), and the inverse of the cost of enforcing contracts (cost as percent of claim). Since these variables are correlated, we use principal components analysis to construct an index which captures the underlying common variance of those four variables (See pair-wise correlations in Appendix II. Table 1).[14] The index is normalized so a value of

[12] Empirical studies use both ratios, see Aspach, Nier and Thiesset (2005) and Dinger (2009). The ratio of liquid assets to liabilities is the most consistent with the notion of CAPDR banks self-insuring against deposit shocks, though banking theory also emphasizes asset-side liquidity problems (Diamond and Rajan, 2005).

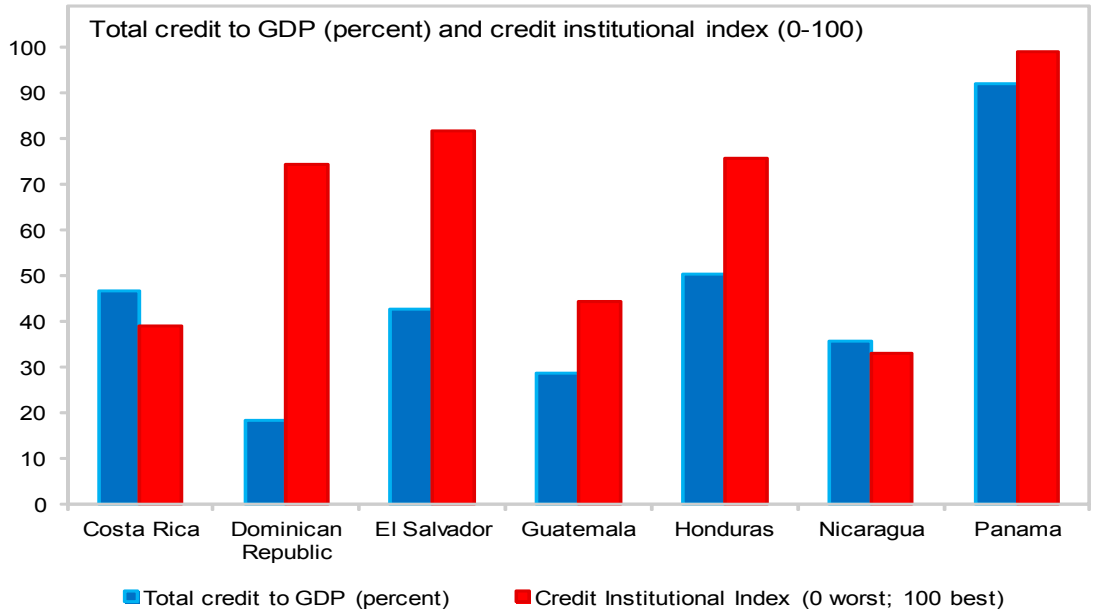
[13] Available on the internet at www.doingbusiness.org.

[14] Principal components analysis is a multivariate statistical technique that uses *n* correlated variables, and reduces their dimension such that each component is a linear combination of the initial variables, and components are orthogonal with each other. The components are ordered so that the first component accounts for as much of the variability in the original data as possible. We use the first component as our index of the

(continued…)

zero represents the lowest quality of credit institutions, and 100 the highest. Although both measures of financial development are highly correlated in some CAPDR countries (e.g. Panama, Nicaragua), they differ quite radically in others (e.g. the Dominican Republic, El Salvador) (Figure 6). Whereas credit-to-GDP is an outcome variable that captures both supply and demand factors, the quality of credit institutions is more likely associated with obstacles to the supply of credit. In this case, the lack of alternative investment opportunities, rather than pure precautionary motives, would also explain high levels of bank liquidity.

Figure 6. Financial Development Indicators in CAPDR



Sources: WEO database, Doing Business database; IMF staff calculations

Moral hazard and safety nets

We construct an index variable categorizing the existence of each of the four pillars of a safety net in each country (regulation and supervision, banking resolution, LOLR facility, and deposit insurance scheme). We attribute a value of 1 if the pillar is present and functioning in a country, so the index can vary between zero and four, though in practice all countries have banking regulation and supervision systems in place (Appendix II, Table 2). Dollarization is measured as the share of dollar deposits in total system deposits (no currency breakdown is available for bank-level data in BankScope). Net international reserves holdings capture the dollar LOLR function of central banks.

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quality of credit institutions in CAPDR, which we normalize to bound its values between 0 and 100 (see Cárdenas and Henao, 2010, for an application).

Data description

Table 2 below presents the variable definitions, expected sign and data sources, and Appendix II, Table 1 in annex describes the data. Overall there is significant variation in liquidity holdings in the sample. Liquidity holdings in terms of customer deposits and short-term funding are on average 25 percent in our sample, and represent about 18 percent of total assets. Average capitalization is relatively high at about 13 percent, as noted in Basso, Delgado and Meza (2012). Foreign banks represent 45 percent of observations, and private banks about 90 percent. Deposit dollarization amounts to about 50 percent, though with wide variations across countries (see Table 1).

Table 2. Variables Used in the Empirical Estimation

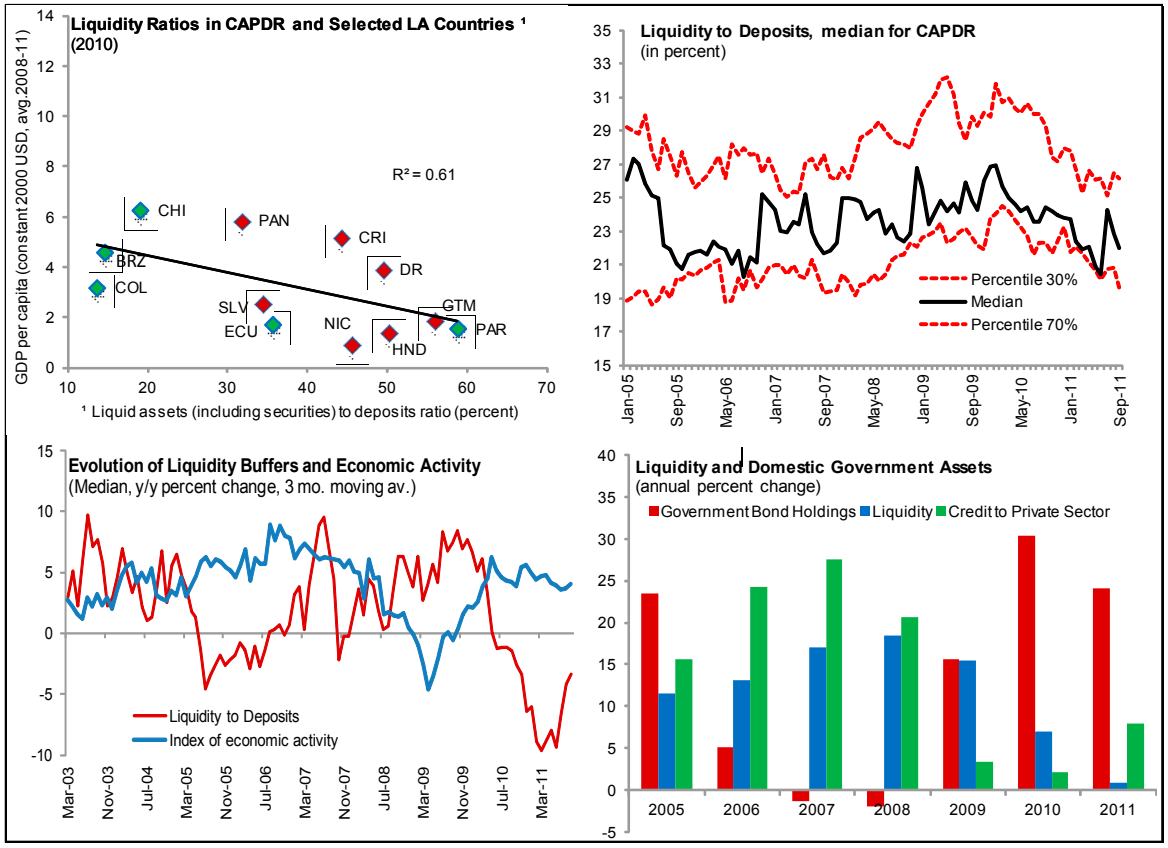
Variable Name (expected sign)	***Concept***	***Measurement***	***Data source***
Dependent variable			
Liquidity ratio	Liquid assets to customer deposits and short-term funding	(Cash, short-term claims on other banks (including CDs) and where appropriate the trading portfolio)/Customer deposits and short-term funding.	BankScope
	Liquid assets to total assets	(Cash, short-term claims on other banks (including CDs) and where appropriate the trading portfolio)/total assets.	BankScope
Explanatory variables			
Bank Characteristics			
Lagged liquidity ratio (+)	Liquidity buffers should be persistent over time	See above for definition	BankScope
Capitalization (-)	Better capitalized banks should have easier access to markets and thus hold less liquidity.	Ratio of equity to total assets.	BankScope
Net Interest Income to Average Earning Assets (-)	Profitability: more profitable banks should hold less liquidity.	(Interest income-interest paid)/ interest earning assets.	BankScope
Loan-loss reserves ratio (+)	Perceived riskiness by banks of their loan portfolio: banks anticipating higher losses should hold higher liquidity buffers.	Ratio of loan-loss reserves to gross loans.	BankScope
Size (-)	If small banks are financially constrained than they should hold more liquidity.	Natural logarithm of total assets.	BankScope
Foreign ownership (-)	Foreign banks should be less financially-constrained than domestic banks and thus hold lower levels of liquid assets.	Dichotomous variable (1 for foreign; 0 for domestic). A distinction is also made between foreign subsidiaries and branches.	BankScope, country desks

Private ownership (+)	Public banks could have less incentives to hold liquid assets as they benefit from an implicit state guarantee	Dichotomous variable (1 for private; 0 for public).	BankScope, country desks.
Macroeconomic fundamentals			
Real GDP growth (-)	Imperfect capital markets imply that liquidity buffers should be countercyclical.	Annual growth rate of real GDP per capita.	IMF country desks
Interest Rate Spread (-)	Measure of the opportunity cost of holding liquid assets.	Difference between average lending and deposit rate	CAPDR Monitor, IMF country desks.
Country Characteristics			
Deposit volatility (+)	Higher aggregate deposit volatility forces banks to hold more liquid assets to hedge against unanticipated deposit withdrawals.	Coefficient of variation of monthly system-wide deposits during one year.	IMF country desks.
Inflation volatility (+)	High inflation volatility is a proxy for macroeconomic instability.	Coefficient of variation of monthly inflation during one year.	WEO.
History of banking crisis (+)	Banks in countries that have experienced a banking crisis should hold higher liquidity buffers.	Dichotomous variable (1 if country experienced a banking crisis in the past 50 years).	Laeven and Valencia (2012)
Credit-to-GDP ratio (-)	Captures financial development. More developed economies should have less financial constraints.	Total credit to the private sector as percent of GDP.	SECMCA
Quality of credit institutions index (-)	Financial constraints should be lower in countries with better credit institutions	Index capturing the quality of credit institutions (0 is worst, 100 best).	World Bank Doing Business Database
Moral hazard and safety nets			
Deposit dollarization (+)	The higher the dollarization, the lower the effectiveness of the domestic lender of last resort.	Share of foreign-exchange deposits in total deposits (system-wide).	IMF country desks
Net international reserves (-)	In partially dollarized economies, NIR capture the capacity of the central bank to act as a lender of last resort in case of a foreign currency shock.	Natural logarithm of net international reserves	IFS
Lender of last resort (-)	Incentives to hold liquidity decline with a strong safety net.	Index variable categorizing the existence of each of the 4 pillars of a safety net (regulation, banking resolution, LOLR and deposit insurance.	Bolzico et al.(2010), Guerrero et al. (2010)

B. Stylized Facts

At the country level, CAPDR banks' liquidity holdings are above liquidity ratios in larger South American countries, with the exception of Paraguay. Liquidity ratios have remained fairly stable during the past decade including the global financial crisis (though with variations across countries) – and have moved countercyclically, increasing when lending opportunities were low and decreasing when they were high, consistently with modern banking models' predictions. Lower credit demand and implementation of countercyclical fiscal policies during the crisis also led to an increase in banks' holdings of government securities over the past few years (Figure 7).

Figure 7. CAPDR: Liquidity Indicators



Source: CAPDR Central Banks, Superintendencies' websites, WEO; Fund staff calculations.

Moving to our bank sample, Table 3 summarizes the relationships between key explanatory variables and liquidity ratios. More specifically, it shows the sample mean of explanatory variables by liquidity quartile (with the quartiles being ranked from low to high). We are interested in whether the characteristics of banks with high liquidity buffers (in the fourth quartile) are different from those with low liquidity buffers (first quartile). Thus the last column of the table shows whether the difference in the means of the variables for banks in the 4th liquidity quartile versus the first quartile is statistically significant.

Table 3. Dependent Variables Means by Liquidity Ratio Quartiles

	Liquidity ratio quartile				*(4^{th} - 1^{st}*	
	1^{st}	*2^{nd}*	*3^{rd}*	*4^{th}*	*quartile)*	*p-value 1/*
Mean of Liquidity to customer and short-term funding ratio	*11.93*	*18.91*	*25.38*	*46.87*		
Loan Loss Reserves to Gross Loans	3.47	3.11	3.14	3.16	-0.32	0.46
Net Interest Margin	9.73	8.71	8.53	8.09	-1.64	0.26
Capitalization (equity to asset ratio)	13.69	11.52	11.88	15.55	1.86	0.23
Bank Size (log of total assets)	12.87	13.00	13.02	12.36	-0.51	0.03
Foreign ownership dummy (=1 if foreign bank)	0.41	0.38	0.53	0.43	0.02	0.74
Private ownership dummy (=1 if private bank)	0.88	0.89	0.94	0.94	0.07	0.07
Real GDP growth	3.24	4.40	3.50	4.04	0.80	0.32
Net International Reserves	2946.79	3443.16	2947.53	2515.13	-431.67	0.00
CPI volatility	2.27	2.10	2.01	1.87	-0.40	0.01
Interest rate spread	9.41	8.32	8.12	7.28	-2.13	0.00
Deposit volatility	3.91	4.06	3.53	3.94	0.03	0.91
Deposit dollarization	37.56	44.21	52.39	64.93	27.36	0.00
Banking crisis dummy (=1 if country had banking crisis after 1970)	0.53	0.55	0.72	0.88	0.35	0.00
Financial safety net (categorical variable, 1-4; 4=comprehensive safety net)	3.08	2.63	2.66	2.50	-0.58	0.00
Credit to GPD (%)	43.86	44.52	48.86	54.81	10.94	0.00
Quality of credit institutions index (0=worst; 100=best)	66.27	58.46	71.75	78.44	12.17	0.00
Memorandum item						
Number of observations	120	109	112	107		

Source: Authors' calculations

1/ P-value from a test of statistical difference of the means of the 4^{th} quartile versus the 1^{st} quartile.

Overall most proposed explanatory variables exhibit the predicted relationship to liquidity buffers, though not all the differences between the first and last quartile are significant. As compared to those in the first liquidity quartile, observations (bank/years) for which observed liquidity is high also tend to be less profitable, smaller, and private. They also have a lower probability to be in a country with a relatively low interest rate spread, low deposit dollarization, a history of banking crisis, an incomplete financial safety net. High liquidity also seems associated with lower quality of financial institutions.[15] However, high liquidity also seems to be associated with lower inflation volatility and higher financial depth.

[15] Given that our time dimension is relatively short, and that it covers the period of the global financial crisis period, we are also interested in testing whether the behavior of the main explanatory variables was different pre-, during- and post-crisis. We find that for the crisis years (2008-09) the main relationships identified for the whole sample continue to hold (Tabulations available upon request).

C. Empirical Analysis

Baseline Specification

In line with the discussion in the previous section and similar to other studies (Aspach et al., 2005, Barajas et al., 2010, and Dinger, 2009), we estimate the determinants of the liquidity buffers based on bank characteristics, macroeconomic fundamentals and country specific-characteristics.

The baseline specification can be represented by equation (1):

$$L_{it} = \beta_0 + \beta_1 L_{ij,t-1} + \beta_2 bank_{ijt} + \beta_3 macro_{jt} + \beta_4 country_{jt} + \mu * j + \nu * t + \xi_{ijt} \quad (1)$$

Where the subscripts *i, j* and *t* refer to bank, country and time (year) respectively. *L* represents bank level liquidity buffers. We include a lagged dependent variable: if, as predicted by theory, banks target an optimum level of liquidity holdings, then we should expect these holdings to be persistent over time, as shown by Opler et al. (1999) in the case of U.S. firms. *Bank* denotes variables measuring bank fundamentals and are derived from the balance sheets of banks. *Macro* represents the macroeconomic determinants of individual banks' liquidity buffers such as real GDP growth and interest rates, and *country* are observable country level characteristics, including, for ease of presentation, the moral hazard and safety net variables presented in the previous section and Table 2. Unobservable country and time effects are captured by country (j) and time (t) dummy variables.

Hypotheses of interest

Based on our review of the theoretical and empirical literature as well as stylized facts on liquidity data for CAPDR countries, we will pay particular attention to the following:

(i) Does ownership matter? We test separately for the effect of private vs. public ownership, and domestic vs. foreign. As discussed in Section III, ownership may not only on exert a direct influence on liquidity holdings, as discussed in section of ownership on liquidity holdings, but may also affect the regression slope through interactions with other explanatory variables. To test this hypothesis, we interact the relevant ownership dummy variable (own_{ijt}) with the other explanatory variables as shown in Equation (2):

$$L_{it} = \beta_0 + \beta_1 L_{ij,t-1} + \beta_2 bank_{ijt} + \beta_3 macro_{jt} + \beta_4 country_{jt} + (\beta_5 bank_{ijt} * own_{ijt}) + (\beta_6 macro_{jt} * own_{ijt}) + (\beta_7 country_{jt} * own_{it}) + \mu * j + \nu * t + \xi_{ijt} \quad (2)$$

(ii) We use the same framework to test whether liquidity buffers (banks perceived need for self-insurance) are higher in countries with more dollarized banking systems, as measured by the share of foreign currency deposits in total deposits. We also test whether liquidity buffers might be higher in countries with less comprehensive financial safety nets.

Estimation Methodology

Equations (1) and (2) are first estimated by Ordinary Least Squares (OLS) using the *Least Squares Dummy Variable* approach. This methodology enables us to introduce and identify bank, country and time effects on bank level liquidity. However, there may also be unobserved bank-specific and/or country specific time-invariant heterogeneity, which could bias our estimates if not properly accounted for. The error term may contain time varying bank or country-specific characteristics which may be correlated with banks' liquidity ratios. Another issue is potential endogeneity of some of the explanatory variables such as credit to GDP.

To address these concerns, we also estimate equations (1) and (2) using the *Generalized Methods of Moments (GMM)* developed by Blundell and Bond (2000) and Bond (2002). GMM estimators are particularly appropriate to address the dynamic panel bias that arises in the presence of lagged dependent variables in samples with a large number of groups (N) and a relatively small number of time periods (T), such as ours. Given persistent liquidity ratios, our preferred estimator is the Systems GMM as it helps overcome the weak instrument problem (past changes do contain information about current levels), and results in improvements in the efficiency of the estimates (Arellano and Bond, 1991, Roodman, 2006).[16]

D. Results

Tables 4a and 4b present estimation results of a parsimonious robust specification of equations 1 and 2 above, using the ratio of liquid assets to customer and short-term funding as a dependent variable.[17] Table 4a includes the credit-to-GDP ratio as a proxy for financial depth, while Table 4b presents estimation results including the index of the quality of credit institutions.

[16] This was implemented in STATA using Roodman's (2006) xtabond2 routine. To avoid instrument proliferation, we restrict the number of lags for the GMM instruments to 2 (Roodman, 2009). We treat the bank size, country and year dummy variables as predetermined and the rest as endogenous. In addition to OLS (whose estimate of the lagged dependent variable coefficient is biased upward) we also estimated the model with robust fixed effects (with the coefficient on the lagged dependent variable is biased downward). Results of the fixed effects estimations are in line with those from OLS and GMM estimates (shown for the baseline specification in Appendix IV, Table 2).

[17] Given the limited time span of our panel, the coefficients on the macroeconomic variables (real GDP growth, interest rate spread) were overall consistent with predictions but not significant nor very robust, as part of the effect of these variables on liquidity buffers was likely captured by the country and time dummies. GMM estimation of the full model also became difficult as the number of instruments was becoming too large relative to available observations.

Baseline specification

Estimation results from the baseline specification are very robust to the choice of financial development variable (Tables 4a and 4b, columns 1 and 2). They show that liquidity buffers in CAPDR are persistent: the coefficient on the lagged dependent variable is positive and significant. This is consistent with the view that banks target an optimal or desired level of precautionary liquidity holdings, but could also be attributed to the presence of structural obstacles to credit that lead banks to hold higher liquidity buffers.

Liquidity ratios are related to bank size, though with non-linearities: liquidity holdings increase with bank size, but there is a point at which bank size begins exhibiting a marginal decreasing effect on liquidity. This is the opposite of what is found by Dinger (2009) in Eastern Europe, and may be explained by differences in the distribution of bank size in both regions. In CAPDR, the distribution of banks is highly skewed with quite high concentration of assets in a few large banks, as indicated in Table 1.[18]

Liquidity holdings are also negatively related to the loan-loss reserve ratio, indicating that banks with higher savings against potential losses or riskier loan portfolios also tend to have lower liquidity buffers in CAPDR. They are negatively associated (though the relationship is not as robust as for the previous two variables) with the net interest margin, as expected. The coefficient on capitalization is negative and significant in the baseline, indicating that better capitalized banks would tend to hold less liquidity (the coefficient remains negative but is generally no longer significant in the specifications with interaction terms). This is somewhat counterintuitive, as the expectation would be that better capitalized banks would also hold more liquidity buffers, if higher capitalization is indicative of a prudent business model. In Table 4a, the credit-to-GDP ratio is negatively related to liquidity buffers, in line with predictions (though the coefficient is not significant). In table 4b, the coefficient on the credit institutions variable is positive and significant in the GMM regression.[19]

Specifications with interaction terms—the role of bank ownership

Results indicate that ownership has some effect on liquidity holdings, though mostly through the interaction terms. Our results do not show any significant evidence that private ownership does affect liquidity buffers, though the coefficient on private ownership is positive in the GMM specification (consistent with Table 3). Foreign banks tend to hold less liquidity, but the coefficient on ownership is not statistically significant either. Foreign banks with riskier loan portfolios or which are more conservative regarding expected loan losses do tend to

[18] In estimations without the quadratic term the coefficient on bank size is negative and robust across specifications as expected from theory and found in related empirical studies (results available upon request).

[19] Estimating a more comprehensive model including all macroeconomic fundamentals presented in Table 2 indicate that the results on bank characteristics and variables of interest remain robust. However, as indicated before the macroeconomic variables are not very precisely estimated in our short panel and although coefficients on these variables are overall in line with predictions they are neither always consistent nor significant.

have higher liquidity buffers (Table 4a, column 6). This is consistent with predictions and findings in Detragiache, Tressel and Gupta (2008), which show that foreign banks tend to be more prudent and lend to less risky customers.

Specifications with interaction terms—deposit dollarization

As indicated in columns 7–8 of Tables 4a and 4b, deposit dollarization is robustly and significantly associated with higher liquidity buffers, both by itself (in both tables) and through interactions with other bank-level variables (Table 4b). The individual effect is quite large: a one standard deviation (34 percent) increase in deposit dollarization leads to a 70 to 100 percent increase in the liquidity to deposit ratio.[20] The strong positive association between deposit dollarization and liquidity buffers may however not necessarily indicate a direct causal relationship. The same factors that cause households and firms to hold more dollar deposits could very well also lead banks to hold more precautionary liquidity.[21] Nonetheless, the positive relationship between dollarization and high liquidity holdings would provide yet another reason why the monetary transmission mechanism is slower in more dollarized economies (as in Medina Cas, Carrion-Menendez and Frantischek, 2011).

The interaction with the loan-loss reserve ratio also indicates that prudent banks or banks with risky loan portfolios in dollarized economies tend to hold more liquidity (though the coefficient is not significant in the GMM specification). More profitable banks in dollarized economies tend to hold less liquidity. The relation between dollarization and the quality of credit institutions is interesting: whereas there is a positive and significant association between the quality of credit institutions and liquidity buffers, the sign of the coefficient switches when institutions are interacted with the degree of deposit dollarization. As mentioned above, this negative association may indicate either that high dollarization itself is a result of lower quality of domestic credit institutions, or that sound credit institutions in dollarized economies help reduce bank liquidity.

Specifications with interaction terms—financial safety net

Columns 9 and 10 of Tables 4a and 4b show the interactions with the financial safety net variable. Though not significant, the coefficient on the GMM estimation is negative, indicating that banks in countries with a more comprehensive financial safety net tend to hold

[20] Given that reserve requirements are set at the same rate for local and foreign currency deposits in most countries, and that actual liquidity holdings are held above requirements, it is unlikely that this result is driven mechanically by reserve requirements. However, the large standard deviation is in part due to the fact that the share of foreign deposits in total is 100 percent in El Salvador and Panama.

[21] De Nicoló, Honahan and Ize (2005) find in a large cross-country sample that the credibility of macroeconomic policy and the quality of institutions are key determinants of deposit dollarization.

Table 4a. Determinants of Banks' Liquidity Buffers in CAPDR-Financial Depth

Dependent variable is the ratio of total liquid assets to customer deposits and short-term funding	Baseline		Variable = Private ownership		Foreign ownership		Dollarization		Safety net	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Pooled OLS	GMM	Pooled OLS	GMM	Pooled OLS	GMM	Pooled OLS	GMM	Pooled OLS	GMM
Liquid assets ratio (-1)	0.347***	0.189***	0.355***	0.218*	0.371***	0.231**	0.336***	0.223**	0.345***	0.290***
	(0.064)	(0.044)	(0.065)	(0.114)	(0.072)	(0.099)	(0.067)	(0.092)	(0.064)	(0.086)
Bank size	7.401***	7.994***	7.327***	8.545***	7.635***	10.381**	8.460***	5.639**	8.326***	7.281***
	(1.448)	(1.875)	(1.472)	(2.299)	(1.609)	(4.137)	(1.629)	(2.635)	(1.354)	(1.546)
Bank size squared	-0.350***	-0.371***	-0.351***	-0.392***	-0.366***	-0.483**	-0.401***	-0.244*	-0.392***	-0.325***
	(0.064)	(0.092)	(0.065)	(0.126)	(0.073)	(0.203)	(0.072)	(0.129)	(0.061)	(0.073)
Capitalization	-0.355***	-0.321**	-0.318***	-0.505	-0.288***	-0.316	-0.219	-0.017	-0.375	-0.238
	(0.060)	(0.123)	(0.043)	(0.336)	(0.058)	(0.305)	(0.220)	(0.542)	(0.299)	(0.928)
Net interest margin	-0.156**	-0.123	0.718	-0.089	-0.278*	-0.593	-0.210	0.404	0.577	1.278*
	(0.064)	(0.076)	(0.569)	(1.067)	(0.164)	(1.199)	(0.133)	(0.331)	(0.359)	(0.690)
Loan-loss reserve ratio	-0.224	-0.282	-0.505**	-0.035	-0.419***	-0.550	-1.252***	-0.799	1.738	0.780
	(0.160)	(0.252)	(0.216)	(0.588)	(0.160)	(0.506)	(0.394)	(0.624)	(1.092)	(1.743)
Credit to GDP ratio	-0.213	-0.323	-0.337	0.404	-0.277	-0.441	-0.374	-0.041	0.342	-0.593
	(0.272)	(0.292)	(0.283)	(0.664)	(0.275)	(0.344)	(0.756)	(0.679)	(0.717)	(0.729)
Variable			-2.623	42.500	-3.002	-13.249	**1.068****	**1.491*****	7.345	-32.043
			(6.514)	(36.406)	(6.185)	(18.512)	(0.516)	(0.470)	(7.880)	(33.069)
Capitalization*variable			-0.105	0.077	-0.332	0.161	-0.003	-0.001	0.022	-0.001
			(0.128)	(0.616)	(0.240)	(0.647)	(0.004)	(0.014)	(0.142)	(0.301)
Net interest margin*variable			-0.868	0.036	0.083	0.309	0.001	-0.022	**-0.224****	**-0.401***
			(0.576)	(1.128)	(0.180)	(1.058)	(0.005)	(0.015)	(0.112)	(0.218)
Loan-loss reserve ratio*variable			0.346	-0.077	**1.585***	**2.858****	**0.043*****	0.027	**-0.613***	-0.259
			(0.347)	(0.827)	(0.817)	(1.291)	(0.015)	(0.022)	(0.344)	(0.568)
Credit to GDP ratio*variable			0.190	-1.283	0.063	0.169	-0.004	-0.012	-0.257	0.199
			(0.119)	(0.880)	(0.064)	(0.282)	(0.012)	(0.009)	(0.285)	(0.297)
Observations	321	321	321	321	321	321	321	321	321	321
R-squared	0.55		0.55		0.57		0.58		0.57	
No. of groups		96		96		96		96		96
No. of instruments	.	64		54		54		64		54
Hansen test p-value		0.348		0.192		0.132		0.232		0.249
A-B AR(2) test		1.283		1.027		1.040		1.562		1.283
A-B AR(2) test p-value		0.199		0.305		0.298		0.118		0.200

Source: Authors' calculations.

Notes: Robust standard errors in parentheses. *** Coefficient significant at the 1 percent level; ** at the 5 percent level; * at the 10 percent level

Dependent variable is the ratio of total liquid assets to customer deposits and short-term funding. GMM is two-step system GMM estimator with Windmeijer standard error correction.

Columns (3) through (10 test the hypotheses that ownership (foreign/domestic and public/private), degree of dollarization and coverage of the financial safety net affect banks' liquidity buffers

Ownership is captured by dummy variables (=1 if the bank is private, =1 if the bank is foreign), dollarization by the share of dollar deposits in total deposits at the country level. Safety net is an index variable categorizing the existence of each of the 4 components of a safety net in each country (Appendix II. Table 1).

All regressions include time and country dummies. Constant estimated but not reported.

Table 4b. Determinants of Banks' Liquidity Buffers in CAPDR-Credit Institutions

Dependent variable is the ratio of total liquid assets to customer deposits and short-term funding	Baseline		Variable = Private ownership		Foreign ownership		Dollarization		Safety net	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
	Pooled OLS	GMM	Pooled OLS	GMM	Pooled OLS	GMM	Pooled OLS	GMM	Pooled OLS	GMM
Liquid assets ratio (-1)	0.346***	0.180***	0.355***	0.350**	0.377***	0.298**	0.342***	0.280**	0.346***	0.267**
	(0.064)	(0.047)	(0.065)	(0.134)	(0.069)	(0.148)	(0.067)	(0.114)	(0.064)	(0.107)
Bank size	7.441***	8.027***	7.301***	5.349**	7.142***	7.070**	8.318***	6.768***	8.287***	7.904***
	(1.486)	(2.059)	(1.536)	(2.099)	(1.539)	(2.752)	(1.550)	(2.548)	(1.381)	(1.661)
Bank size squared	-0.352***	-0.384***	-0.348***	-0.238**	-0.343***	-0.325**	-0.395***	-0.306**	-0.389***	-0.354***
	(0.065)	(0.096)	(0.068)	(0.108)	(0.068)	(0.137)	(0.069)	(0.127)	(0.061)	(0.084)
Capitalization	-0.356***	-0.336***	-0.316***	-0.423	-0.283***	-0.180	-0.217	-0.026	-0.390	-0.461
	(0.061)	(0.106)	(0.050)	(0.424)	(0.061)	(0.393)	(0.220)	(0.537)	(0.300)	(0.956)
Net interest margin	-0.160**	-0.141*	1.115**	1.945	-0.235	-0.546	-0.191	0.489	0.573	1.293*
	(0.063)	(0.083)	(0.552)	(1.851)	(0.158)	(0.968)	(0.132)	(0.317)	(0.349)	(0.678)
Loan-loss reserve ratio	-0.211	-0.299	-0.292	0.415	-0.351**	-0.252	-1.292***	-1.236	1.879*	1.283
	(0.159)	(0.300)	(0.178)	(0.639)	(0.153)	(0.526)	(0.404)	(1.033)	(1.054)	(2.196)
Credit Institutions 1/	0.051	0.053*	0.113	0.174	0.047	0.001	0.188**	0.153*	0.685***	0.788**
	(0.035)	(0.028)	(0.073)	(0.161)	(0.035)	(0.051)	(0.089)	(0.086)	(0.209)	(0.355)
Variable			**11.918***	27.989	0.579	6.271	**0.774****	**0.718****	**17.220*****	**33.601***
			(6.497)	(28.631)	(4.080)	(18.141)	(0.304)	(0.303)	(2.981)	(19.225)
Capitalization*variable			-0.109	-0.054	-0.367	-0.034	-0.003	-0.005	0.033	0.120
			(0.129)	(0.849)	(0.236)	(0.716)	(0.004)	(0.013)	(0.141)	(0.320)
Net interest margin*variable			**-1.269****	-1.987	0.032	0.205	0.000	**-0.025***	**-0.225****	**-0.419***
			(0.558)	(1.862)	(0.173)	(0.927)	(0.005)	(0.015)	(0.109)	(0.211)
Loan-loss reserve ratio*variable			0.132	-0.407	**1.296***	1.910	**0.047*****	0.050	**-0.640***	**-0.419**
			(0.298)	(0.764)	(0.682)	(1.466)	(0.015)	(0.038)	(0.332)	(0.609)
Credit Institutions*variable 1/			-0.061	-0.148	0.018	-0.074	**-0.007****	**-0.006****	**-0.186*****	**-0.212****
			(0.066)	(0.156)	(0.039)	(0.118)	(0.003)	(0.002)	(0.061)	(0.087)
Observations	321	321	321	321	321	321	321	321	321	321
R-squared	0.55		0.55		0.57		0.59		0.57	
No. of groups		96		96		96		96		96
No. of instruments	.	64		54		54		64		54
Hansen test p-value		0.338		0.0836		0.134		0.125		0.290
A-B AR(2) test		1.470		1.481		0.914		1.115		1.264
A-B AR(2) test p-value		0.141		0.139		0.360		0.265		0.206

Source: Authors' calculations.

Notes: Robust standard errors in parentheses. *** Coefficient significant at the 1 percent level; ** at the 5 percent level; * at the 10 percent level

Dependent variable is the ratio of total liquid assets to customer deposits and short-term funding. GMM is two-step system GMM estimator with Windmeijer standard error correction.

Columns (3) through (10 test the hypotheses that ownership (foreign/domestic and public/private), degree of dollarization and coverage of the financial safety net affect banks' liquidity buffers

Ownership is captured by dummy variables (=1 if the bank is private, =1 if the bank is foreign), dollarization by the share of dollar deposits in total deposits at the country level. Safety net is an index variable categorizing the existence of each of the 4 components of a safety net in each country (Appendix II. Table 1).

All regressions include time and country dummies. Constant estimated but not reported.

1/ Credit institutions are proxied by the principal components analysis of the Doing Business variables measuring the quality of credit institutions.

less liquidity. The interaction between the safety net and net interest margin is negative, indicating as mentioned above that profitable banks in countries with more comprehensive safety nets do hold less liquidity. This is in contrast with the coefficient on the interest margin (without interactions), which is significant and positive in column 10 of Table 4a. Compared with the baseline, it seems that the absence of a safety net would lead even profitable banks to hold an extra liquidity cushion. Table 4b, columns 9-10 show estimation results with the financial safety net variable and interactions, including the quality of credit institutions variable. As in the case of deposit dollarization, whereas the sign of the coefficients for credit institutions and safety net variables are now positive and significant, the coefficient on the interaction term between safety net and credit institutions is negative: when the safety net is less comprehensive and the quality of institutions is low, banks would hold more precautionary liquidity buffers. Further, as in Table 4a, if the safety net is comprehensive, more profitable banks or banks with higher loan loss reserves tend to hold less liquidity.

Robustness checks

As a main robustness check, we estimate our model using the ratio of liquid assets to total assets as our dependent variable (Appendix IV. Table 1). Overall results are broadly consistent with the findings presented in Tables 4a and 4b, at least in terms of signs of coefficients. The coefficient on the lagged dependent variable is about twice as large, and the coefficient of the dollarization variable remains significant and relatively large.

Appendix IV, Table 2 presents further robustness checks. These include running the fixed effects regressions as discussed in footnote 16 above (column 3), and looking into the interactions of foreign ownership, dollarization and safety net only for the private banks of the sample (columns 4-9). One caveat is that limiting the number of observations increases the risk of overfitting the model due to too many instruments. Nonetheless, the Hansen statistic's p-value remains reasonable for all specifications.

These additional regressions support our main findings. The relative size of the coefficient on the lagged dependent variable in the pooled OLS, fixed effects and GMM is consistent with expectations: in OLS this coefficient is correlated with the error term and biased upward, while in the fixed effects specification it is the opposite. Good estimates of the true parameter should lie in between or near these values, which is the case here (see column 2 of Appendix IV. Table 2). Previous results on ownership, dollarization and safety net hold in the private banks sample, particularly as regards the role of credit institutions in highly dollarized economies or economies with a less comprehensive safety net.

Our results still need to be considered against the caveat of data limitations. The uneven coverage of individual countries' banking systems and short estimation time frame may affect the coefficient estimates from the regressions. Nevertheless, some useful policy lessons already emerge from our analysis. These are discussed in the following section.

V. CONCLUSIONS AND POLICY LESSONS

Our study of liquidity buffers in CAPDR finds that they are comfortably above legal and prudential requirements. With average liquidity ratios of about 25 percent of deposits, banks in the region have handled and are able to handle historic deposit volatility levels outside of crisis episodes (Table 5). Therefore, the adoption of the new Basel III liquidity requirements in the region should not have much impact on banks' balance sheet.[23] Indeed, Basso, Delgado and Meza (2012) find that liquidity holdings in the region already meet or exceed the new Basel III ratios.

Table 5. CAPDR: Largest deposit drop (December 2001-September 2011)
(Percent)

	Deposits														
	Total			Demand			Time & Savings			Foreign Currency			Local Currency		
	no. of months			no. of months			no. of months			no. of months			no. of months		
	1	3	6	1	3	6	1	3	6	1	3	6	1	3	6
Costa Rica	3.3	4.9	4.7	5.6	6.8	5.6	7.4	9.9	12.1	6.7	9.6	15.2	3.8	5.4	5.2
Dominican Republic	34.4	23.7	13.5	54.5	40.1	27.6	30.0	20.0	10.6	19.9	30.6	35.0	45.5	31.7	22.5
El Salvador	2.7	3.0	3.9	17.8	17.4	17.8	2.2	3.2	4.1				2.7	3.0	3.9
Guatemala	3.1	1.8	0.6	6.2	6.7	5.6	5.3	5.2	3.1	5.6	4.1	1.1	3.5	3.0	1.6
Honduras	3.0	3.8	3.3	10.3	8.8	10.2	2.3	3.2	3.7	7.4	9.4	10.0	0.3	5.3	5.4
Nicaragua	1.7	4.2	3.0	10.8	11.2	11.4	2.9	4.9	3.1	3.4	5.1	6.1	6.6	4.2	4.5
Panama	3.7	6.3	7.7	8.9	8.1	8.7	3.1	2.0	2.1				3.7	6.3	7.7
Total	1.7	1.8	0.6	5.6	6.7	5.6	2.2	2.0	2.1	3.4	4.1	1.1	0.3	3.0	1.6

Source: CAPDR Central Banks and superintendencies' websites and Fund staff calculations.
Notes: Largest decline in bank deposits at the one, three and six months horizon, between December 2001 and September 2011.

A closer look at the reasons for which banks would want to hold liquidity buffers above legal or prudential requirements indicates that CAPDR banks appear guided at least in part by rational precautionary motives. As found in other countries or regions, bank characteristics that influence their ability to raise additional funding on demand play an important role: smaller, lower-capitalized, less efficient and less profitable banks tend to hold higher liquidity buffers. Foreign banks tend to hold less liquidity, possibly because they have access to emergency lines from headquarters. Surprisingly, banks with riskier loan portfolios also hold less liquidity overall, though this is not the case for foreign banks and banks in highly dollarized economies.

A first policy lesson stemming from these results would be to continue with ongoing efforts to strengthen financial sector supervision, enhance financial safety nets and develop financial markets. Greater confidence in the system and more opportunities for investment and

[23] The Basel III liquidity requirements are to be in effect in 2015. The Basel Committee on Banking Supervision has defined two minimum standards for funding liquidity: (i) the liquidity coverage ratio, which aims at promoting short-term resilience of a bank's liquidity profile by ensuring that it has sufficient high-quality liquid assets (cash or cash-equivalent) to survive a significant stress scenario lasting for one month; and (ii) the net stable funding ratio, in order to promote resilience over a longer time period by matching long-term assets with stable funding sources over a one-year horizon (BIS, 2010).

intermediation (through stronger credit institutions) could help lower banks' precautionary liquidity buffers without compromising financial stability.

Strengthened supervision would help address the issue of the negative relationship between the loan-loss ratio and liquidity buffers, which may indicate that domestic banks, in contrast with foreign banks which are likely subject to strict internal guidelines, may not fully internalize the costs of riskier lending practices. As mentioned, further progress in risk-based supervision would be especially warranted: in spite of notable progress, CAPDR countries still do not meet minimum international standards and lag behind larger South American countries.

Another important lesson relates to the dollarization of CAPDR economies and banking systems and calls for strengthening the credibility of macroeconomic policy and institutions, as well as the coverage of financial safety nets. Our findings show that, in our sample, banks' precautionary demand for liquidity is associated to the degree of deposit dollarization, and the safety net, in each country. Given the lack of dollar LOLR in all countries and the lack of a LOLR in the two fully dollarized economies, our findings suggest that continuing with ongoing efforts to strengthen financial safety nets would be efficient. El Salvador has approved legislation to provide emergency liquidity support to banks, and Panama is considering establishing a similar facility.

Furthermore, maintaining higher liquidity buffers because of dollarization also has negative implications for the development of financial markets, and for the adequate functioning of the monetary policy transmission mechanism. For the countries in the region that aim at transitioning to inflation targeting, tackling the root causes of deposit dollarization should be an important part of their strategy. Studies on deposit dollarization find that it is associated with lower credibility of macroeconomic policy, high inflation, and poor quality of institutions; and also find that financial instability is higher in dollarized economies (De Nicoló, Honohan and Ize, 2005, Gulde et al., 2004). Arguably, most CAPDR countries have been successful over the past decade at macroeconomic stabilization, lowering inflation and reducing output volatility (except during the 2008–09 global crisis). Nonetheless, financial dollarization tends to persist even when macroeconomic stability is restored and inflation relatively low if institutions are still perceived to be weak.[24] Even in tightly managed exchange rate regimes, partially dollarized economies are subject to higher liquidity risks, and our results tend to indicate that, at least to some extent, CAPDR banks do internalize these risks.

With causality likely running both from policies to dollarization and back, measures that would help create a "virtuous cycle" of de-dollarization and lower precautionary liquidity holdings could be informed by the experience of de-dollarization in South America. In particular, in a study of financial de-dollarization in Bolivia, Paraguay, Peru and Uruguay,

[24] See Reinhart, Rogoff and Savastano (2003), Galindo and Leiderman (2005), and Erasmus et al. (2009).

Garcia-Escribano and Sosa (2011) find that successful, market-driven de-dollarization was associated with (i) stronger macroeconomic policies and institutions, credibly and consistently implemented over time, (ii) active management of reserve requirement differentials and the introduction of other prudential measures; and (iii) domestic currency capital market development. As discussed in this paper, there is ample room for more active liquidity management on the part of the CAPDR monetary and prudential authorities. Finally, measures to develop local currency capital markets, starting with public domestic debt markets, would enhance financial systems' efficiency, diversify sources of funding and investment opportunities.

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APPENDIX I. RESERVE AND LIQUIDITY REQUIREMENTS IN CAPDR

Most central banks or supervisory authorities require depository institutions to hold minimum reserves or liquidity against their deposits.

Required reserves [1]

In systems with central banks, there are typically two main reasons to require the holdings of reserves:

- *Prudential*: Reserve requirements serve as a safeguard against both liquidity and solvency risk in a case of a sudden and inordinate demand for withdrawals (as in a run on a bank) or as a result of a need to make sudden large payments abroad, for example. In highly dollarized economies, the prudential purpose of the reserve requirements perhaps carries more prominence as central banks have a very limited ability to control monetary policy in the environment of an overwhelming presence of foreign currency.

- *Monetary control and liquidity management*: Adjusting reserve requirements is a policy tool for injecting cash (liquidity) into, or withdrawing it from, an economy. This helps to control domestic liquidity, i.e., commercial bank balance sheet growth. Likewise, adjusting reserve requirements could influence the spread between deposit and lending rates, thereby impacting the growth of monetary aggregates and inflation.

Reserve requirements are calculated in reference to commercial banks' deposits. [2] They can be mandated on both local and foreign currency deposit liabilities at similar or differentiated rates, and on demand, savings and time horizons of these deposits.[3] The reserve requirement is usually defined as a minimum amount of liquid assets, cash or cash-equivalents[4] (computed as a percentage of demand and time deposits), that banks and other depository institutions (credit unions, insurance companies) are required by law to keep on hand, and which may not be used for lending or investing. In countries with underdeveloped financial

[1] This section is based on Gray (2011).

[2] Composition of required reserves depends on individual country requirements. Some countries only allow deposits with the central bank to count as legal reserves and do not allow averaging (calculating the level of deposits on average in one month versus a requirement to hold going forward the end of the month balance, which limits banks ability to manage liquidity).

[3] In cases where the authorities are trying to discourage dollarization, higher reserve requirements may be imposed on foreign liabilities.

[4] Liquidity is defined as the ability of an asset, other than cash, to be converted into cash quickly and without any price discount. In the U.S., e.g., these constitute certificates of deposit (CD), marketable securities, negotiable financial instruments (such as a cashier's checks), etc., that has a very high degree of convertibility into cash (liquidity).

markets, reserve requirements are usually cash in vault, banks' deposits with the central bank or abroad.

In many cases, banks hold liquidity above the required levels at the central bank, especially if they are remunerated.[5] This liquidity could be truly voluntary, implying that banks' hold them for precautionary reasons, and involuntary, reflecting idle balances that banks hold above their demanded levels.[6] In countries with monetary policies, this genuine voluntary liquidity in the banking system may undermine both the central bank's capacity to affect banks' cost of funding and its ability to restrain any rapid unwinding of these reserves, and possible triggering of inflation. This may also induce excessive exchange rate volatility under an abrupt change in expectations, and ultimately jeopardize financial stability. The presence of voluntary reserves could also be an indication of rigidities in the system as excess liquidity creates opportunity costs.

Given the banks' ability to influence monetary conditions through holdings of excess reserves, the monetary authorities ought to carefully monitor these levels. For example, they should ensure that excess liquidity, if needed, could be counteracted by their own provision of reserves to the system. In cases where reserves are remunerated, changing the remuneration rate – rather than conducting open market operations - can signal the stance of the desired monetary policy.

Liquidity requirements

Liquidity requirements are commonly defined as the ratio of liquid assets to liabilities, although definitions can vary by country. Liquid assets generally include cash in vault, deposits abroad, and deposits held at the central bank, as well as liquid securities (central bank paper, quoted government securities). The definition of liquidity requirements differs sometimes quite substantially across countries, as supervisor include eligible securities based on the existence of a well-functioning market guaranteeing that they could be converted into cash quickly and at no or little loss of value.

Application in CAPDR

Reserve and liquidity requirements are relatively homogeneously defined in CAPDR, although there could be differences in definitions of liquid assets. Reserve requirements in five countries consist mostly of cash, cash in vault, and central bank and government

[5] Level of (voluntary) reserves could be higher if they are remunerated by the central bank. Remuneration of reduces the cost of having idle resources and reduces incentives for the financial system to avoid liabilities that require reserve provision.. At the same time, out of 121 central banks surveyed by Gray (2011), 70 percent did not remunerate reserves; and 20 percent remunerated at below primary rate.

[6] Agenor et al (2004).

securities. In El Salvador, deposits abroad are also permitted as a proportion of a reserve requirement.[7]

Eligible liabilities on which requirement is calculated are mostly all deposits, although there are some variations. Some countries limit eligible liabilities to demand and foreign deposits only (Dominican Republic and Honduras). Many countries exclude savings deposits mostly because they are of longer maturity and also because they are not large comparing to demand and time deposits. Reserve requirements in partially dollarized economies tend to be different for local or foreign currency deposits. In CAPDR these average 15 and 15.5 percent, respectively. Dominican Republic has the highest reserve requirement on foreign deposits, at 20 percent (Appendix 1. Table 1).

Reserve requirements are stipulated in central bank laws and form a part of a monetary policy toolkit. Costa Rica and Guatemala have kept ratios constant over the past 5 years, indicating that the requirement serves mostly a prudential objective rather than a monetary policy tool (Appendix I.Table 2). In Nicaragua a downward adjustment in reserve requirement was taken years before the 2008 crisis and the ratio was kept stable during the crisis. In Dominican Republic there was a downward adjustment in local currency reserve requirement in 2009, to inject liquidity. Honduras appears to be the only country where there was an active management of reserves. Only in Nicaragua, total reserves at the central bank continuously exceed the required amounts.

El Salvador, Honduras and Panama also impose prudential liquidity requirements. In Honduras, the liquidity requirement is aimed at avoiding maturity mismatches. In El Salvador, there is a prudential requirement of maintaining at the central bank a liquid reserve amounting to 3 percent of deposits. For Panama, the liquidity requirement (30 percent) includes a vast array of instruments as liquid assets, even obligations payable to banks in 186 days, but the numerator only includes short-term deposits, which raises the ratio significantly, as these constitute only a small share of total deposits.

[7] Perhaps, as a relic of the non-officially dollarized economy, El Salvador preserved a liquid asset *requirement* of 3 percent of deposits (funds to be deposited with the former central bank or with a reputable bank abroad), however, it eliminated it during the 2008 global financial crisis in an attempt to free up liquidity.

Appendix I. Table 1: Legal Reserve and Liquidity Requirements in CAPDR (2010)

Country	Reserve requirements		Remuneration (percent)	Liquidity requirement (percent)	Eligible Liabilities	Compliance Assets	Averaging	Penalty	Purpose/ Last change
	Local Currency (percent)	Foreign Currency (percent)							
Costa Rica	15	15	n.a		Demand, foreign currency, time, interbank, government. Excludes interbank deposits.	Deposits at the central bank (only those at the reserve account) in the some currency than the deposits	15 days maintenance period	Interest rate of discount window over the reserve deficiency	Monetary policy
Guatemala	14.6	14.6	0.6	n.a	All deposits	Cash in vault and deposits at the central bank in the some currency than the deposits	Monthly	n.a	Monetary policy
Honduras	6 (unrem), 12 (remun)	12(unrem), 10(remun)	Only compulsory investments are remunerated at ½ of the policy rate.	Yes; 2 1/	Deposits, expired term deposits, reduced capital contracts and savings stamps and others	Cash in vault, deposits at the central bank, and government bonds in the case of compulsory investment in local currency in the some currency than the deposits	Over a two-week period	Penalties depend on the currency of denomination and the type of institution.	Monetary policy/ 2008-09
Dominican Republic	17	20	Foreign currency reserves are remunerated at Feds overnight rate - 200bps	n.a	Demand, foreign currency, time, interbank, government. Excludes interbank deposits.	18 % in deposits with central bank and 2% cash in vault allowed.	Weekly, holding period ends on Friday	n.a	Monetary Policy/2009
Nicaragua	16.25	16.25	n.a	on excess reserves (n.a.)	All deposits	Cash of CB securities	n.a	Interest charged based on internbank int rate (greater than 1%)	Monetary policy/2005-06
El Salvador	23	n.a	n.a	3	All deposits	25 % in demand deposits at CB or foreign bank, 25% in deposits or CB securities, 50% in CB securities issued for liquidity purposes	Over a two-week period	n.a.	Prudential
Panama	n.a	n.a	n.a	30; 20 (Applies to all onshore general license banks and state-owned Banks at 30.0 for general licence banks; 20.0 for general licence banks that maintain average interbank quarterly deposits exceeding 80 percent of total deposits.	Demand, term deposits up to 186 days (unless portion that guarantees loans in the bank itself), savings deposits. Deposits received from the parent company, branch, subsidiary or affiliated abroad are excluded.	Legal tender in Panama, bank deposits in Panama, bank deposits abroad, obligations issued by foreign governments, obligations issued by foreign private and government agencies, banking obligations payable in Panama up to 186 days, installments of payable obligations up to 186 days, other Liquid Assets.	n.a	n.a	Prudential

Sources: CAPDR Central banks and Superintendencies w ebsites.

1/ Honduras also imposes specific liquidity requirements, based on temporal bands for maturity mismatches. For the first band, the maturity mismatch in cash flow s for the next month must be low er than the amount of liquid assets, w hile the for the second band the maturity mismatch in cash flow s for the next three months must be low er than 1.5 times the liquid assets.

Appendix I. Table 2: Evolution of Reserve and Liquidity Ratios in CAPDR (2005-2010)

(In percent)

Country	Currency	2005	2006	2007	2008	2009	2010
Costa Rica	LCU RR	15	15	15	15	15	15
	FCY RR	15	15	15	15	15	15
Guatemala	LCU RR	14.6	14.6	14.6	14.6	14.6	14.6
	FCY RR	14.6	14.6	14.6	14.6	14.6	14.6
Dominican Rep.	LCU RR	20	20	20	20	17.5 (May -Dec)	17
	FCY RR	20	20	20	20	20	20
Nicaragua	LCU RR	16.25 (Jan-May); 19.25	19.25 (Jan-Sep); 16.25 (Oct-Dec)	16.25	16.25	16.25	16.25
	FCY RR	16.25 (Jan-May); 19.25 (June-Dec)	19.25 (Jan-Sep); 16.25 (Oct-Dec)	16.25	16.25	16.25	16.25
Honduras	LCU RR unremun.	12	12	12	12(Jan-Feb); 10.2 (Mar); 10.1 (Apr); 9.4 (May); 8.8 (June-Sept); 7.5 (Oc-Nov); 4.3 (Dec)	2.6 (Jan); 1.1 (Feb); 1.2 (May-July); 6.1 (Aug)	6
	LCU RR remun.	2 (Jan); 1 (Oct)	1	3 (Jan-Jun); 4 (Jul-Dec)	4 (Jan-Feb); 6 (Mar); 7 (Apr(; 8 (May); 8.8 (June-Dec)	8.8 (Jan.-Jul); 11 (Aug); 12 (Sep-Dec)	12
	FCY RR unrem.	12	12	12	12	12	12
	FCY RR remun.					2 (Apr); 4 (May); 6 (Jun-Jul); 8 (Aug); 81. (Sep); 10 (Oct-Dec)	10
	FCY LR						2
Panama	LR	30; 20	30; 20	30; 20	30; 20	30; 20	30; 20
El Salvador	RR	19.2 (Jan), 19.6 (Feb); 19.8 (Mar-Apr); 19.7 (May); 19.3 (Jun-Jul); 19.7 (Aug);19.4 (Sep);19.6 (Oct); 20.1 (Nov);20.3 (Dec)	20.2 (Jan-Feb); 20.3 (Mar);19.9 (Apr--Jun);19.8 (Jul);20.6 (Aug);19.9 (Sep);20.4 (Oct);20.2 (Nov);20.5 (Dec)	20.4(Jan-Feb);20.6 (Mar);20.7 (Apr);20.8 (May);20.5 (Jun);21.2 (Jul);21.8 (Aug);21.4 (Sep);21.0 (Oct);21.2	20.1 (Jan); 20.8 (Feb);20.4 (Mar);20.6 (Apr);20.2 (May);20.0 (june)20.1 (Jul);20.2 (Aug);20.0 (Sep);20.1(Oct);20.3 (Nov);20.4 (Dec)	20.9(Jan);20.7 (Feb);21.9(Mar);22.7(Apr);23.4(May);23.5(Jun);23.9 (Jul);24.3 (Aug);24.1 (Sep);23.3 (Oct);22.8 (Nov);23.7(Dec)	23.7(Jan);23.4(Feb);23.1(Mar);23.0(Apr);22.6 (May);22.7(June);23.1 (July); 23.5(Aug);23.2 (Sep);23.2 (Oct);23.3 (Nov);23.1 (Dec)
	LR	3.0	3.0	3.0			

Source: CAPDR Central banks and Superintendencies Websites.

Notes: RR is reserve requirement, LR liquidity requirement. LCU is local currency, FCY foreign currency.

Appendix II. Table 1. Correlations between liquidity ratios, credit to GDP and credit institutions in CAPDR [1]

	Liquid assets to customer deposits and short term funding	Liquid assets to total assets	Total credit to GDP	Getting Credit - Strength of legal rights index (0-10)	Getting Credit - Depth of credit information index (0-6)	Getting Credit - Private bureau coverage (% of adults)	Enforcing Contracts - Cost (% of claim)	Institutional Credit index (0-100)
Liquid assets to customer deposits and short term funding	1							
Liquid assets to total assets	0.7598	1						
	(0)							
Total credit to GDP	0.1565	0.19	1					
	-0.0009	-0.0001						
Getting Credit - Strength of legal rights index (0-10)	0.0577	0.0101	0.3555	1				
	(0.2232)	(0.8318)	(0)					
Getting Credit - Depth of credit information index (0-6)	0.1085	0.157	0.333	0.2571	1			
	(0.0216)	(0.0009)	(0)	(0)				
Getting Credit - Private bureau coverage (% of adults)	0.0178	0.0596	0.2076	0.1231	0.5076	1		
	(0.7073)	(0.2082)	(0)	(0.0069)	(0)			
Enforcing Contracts - Cost (% of claim)	-0.197	-0.2523	-0.5936	-0.1544	-0.5436	-0.0342	1	
	(0)	(0)	(0)	(0.0007)	(0)	(0.4545)		
Institutional Credit index	0.1447	0.1882	0.534	0.4873	0.9051	0.6104	-0.6698	1
	(0.0021)	(0.0001)	(0)	(0)	(0)	(0)	(0)	

Source: WEO database, Doing Business database; IMF staff calculations.

[1] P-values in parentheses.

Appendix II. Table 2. CAPDR Financial Safety Nets

	Lender of last resort		Bank resolution		Systemic risk regulation	Deposit Insurance				Safety net variable 2/
	In place	Coverage	Legal protection of supervisor	Partial transfer of uninsured deposits	In place	In place	Coverage	Contributes to bank resolution process	Target fund	
Costa-Rica	yes	50% of liquid assets	low	n/a	no	no	n/a	n/a	n/a	2
Dominican Republic	yes	1.5 times paid capital	high	yes	yes	yes	13,900	yes	5% of total deposits	4
Guatemala	yes	50% of regulatory capital	low	yes	no	yes	2,400	yes	5% of total deposits	3
Honduras	yes	100% of capital and reserves	high	yes	yes	yes	9,600	yes	5% of total deposits	4
Nicaragua	yes	not established by law	medium	yes	yes	yes	10,000	yes	no	4
El Salvador	no/1	n/a	medium	yes	no	yes	9,000	yes	no	2
Panama	no	n/a	low	n/a	no	no	10,000	n/a	n/a	1

Source: Bolzico, J., Gozzi E., and F. Rossini, 2010, Financial Safety Nets in American Countries: A Comparative Analysis;IMF staff calculations.

1/ While by law (2010) the Central Bank is allowed to provide liquidity as a LOLR, in practice this facility is just being established.

2/ Index variable categorizing the existence of each of the 4 pillars of a safety net (regulation, banking resolution, LOLR and deposit insurance), with 4 assigned in presence of all four pillars.

Appendix III. Table 1: Descriptive Statistics

Variable	*No. observations*	*Mean*	*Std. Dev.*	*Min.*	*Max.*
Liquid assets to customer deposits and short-term funding ratio	448	25.3	18.3	2.0	191.0
Liquid assets to total assets ratio	448	18.9	10.4	0.9	75.6
Capitalization (equity to asset ratio)	448	13.2	9.3	2.6	83.0
Loan Loss Reserves to Gross Loans	417	3.2	3.1	0.0	25.0
Net Interest Income to Average Earning Assets	428	8.8	10.5	1.0	87.0
Loan to Asset ratio	448	58.9	17.1	3.3	90.6
Loan growth (y/y, percent)	350	24.0	55.6	-66.2	594.5
Bank Size (log of total assets)	448	12.8	1.7	4.1	16.5
Foreign ownership dummy (=1 if foreign bank)	480	0.4	0.5	0.0	1.0
Private ownership dummy (=1 if private bank)	480	0.9	0.3	0.0	1.0
Interest rate spread	480	8.3	2.9	3.1	16.8
Real GDP growth	384	3.9	5.7	-7.9	15.3
Net international reserves	480	2931.0	1113.3	832.9	5594.9
Deposit dollarization	480	50.2	34.2	13.5	100.0
Banking crisis dummy (=1 if country had banking crisis after 1970)	480	0.7	0.5	0.0	1.0
Financial safety net (categorical variable, 1-4; 4=comprehensive safety net)	480	2.7	1.2	1.0	4.0
Credit to GPD (%)	480	48.8	25.9	17.2	93.7
Quality of credit institutions index (0=worst; 100=best)	480	68.3	28.2	0.0	100.0

Sources: International Financial Statistics, World Economic Outlook Database, Bankscope Database,
CAPDR Central banks and Banking Supervision websites, Laeven and Valencia (2010), Bolzico et al. (2010); IMF staff calculations.

Appendix IV. Table 1. Determinants of Banks' Liquidity Buffers in CAPDR - GMM Estimates

Dependent variable is the ratio of liquid assets to total assets	Baseline		Variable = Private		Foreign ownership		Dollarization		Safety net	
	(1) Credit Institutions	(2) Financial Depth	(3) Credit Institutions	(4) Financial Depth	(5) Credit Institution	(6) Financial Depth	(7) Credit Institutions	(8) Financial Depth	(9) Credit Institutions	(10) Financial Depth
Liquid assets ratio (-1)	0.484***	0.557***	0.539***	0.567***	0.398***	0.483***	0.563***	0.519***	0.543***	0.534***
	(0.112)	(0.098)	(0.101)	(0.089)	(0.118)	(0.101)	(0.088)	(0.093)	(0.106)	(0.114)
Bank size	4.321***	3.861***	3.666***	4.077***	4.850***	5.484***	3.596***	3.815***	4.146***	4.023***
	(0.979)	(0.866)	(1.192)	(1.048)	(1.330)	(1.908)	(0.959)	(1.257)	(0.889)	(0.977)
Bank size squared	-0.201***	-0.180***	-0.171***	-0.197***	-0.232***	-0.262***	-0.167***	-0.179***	-0.191***	-0.187***
	(0.049)	(0.044)	(0.060)	(0.056)	(0.065)	(0.085)	(0.048)	(0.061)	(0.044)	(0.045)
Capitalization	-0.226***	-0.211***	-0.098	-0.192	-0.188	-0.175*	-0.100	-0.063	-0.292*	-0.249
	(0.071)	(0.070)	(0.215)	(0.124)	(0.158)	(0.099)	(0.233)	(0.215)	(0.162)	(0.275)
Net interest margin	-0.047	-0.037	0.096	-0.799	-0.570*	-0.593*	0.197**	0.216	0.203	0.163
	(0.033)	(0.033)	(2.354)	(1.193)	(0.331)	(0.311)	(0.099)	(0.151)	(0.323)	(0.337)
Loan-loss reserve ratio	0.015	-0.036	0.025	0.277	-0.080	-0.292*	-0.467*	-0.178	-0.056	-0.346
	(0.168)	(0.145)	(0.608)	(0.280)	(0.163)	(0.166)	(0.251)	(0.395)	(1.433)	(1.230)
Credit 1/	0.033	-0.181	0.114	0.117	0.044*	-0.295	0.147***	0.249	0.464***	-0.135
	(0.024)	(0.181)	(0.159)	(0.355)	(0.026)	(0.251)	(0.047)	(0.553)	(0.133)	(0.636)
Variable			9.567	16.285	0.403	-5.554	**0.482*** **	**1.336*** **	**21.139*** **	-8.880
			(24.722)	(24.600)	(6.609)	(7.717)	(0.174)	(0.346)	(7.458)	(28.601)
Capitalization*variable			-0.167	-0.071	-0.044	-0.161	-0.002	-0.003	0.053	0.027
			(0.335)	(0.251)	(0.210)	(0.212)	(0.005)	(0.004)	(0.060)	(0.119)
Net interest margin*variable			-0.147	0.756	0.421	0.487	**-0.011*** **	-0.012	-0.080	-0.067
			(2.352)	(1.186)	(0.312)	(0.328)	(0.004)	(0.008)	(0.099)	(0.109)
Loan-loss reserve ratio*variable			0.082	-0.291	0.948	1.340	**0.019** **	0.005	0.016	0.091
			(0.681)	(0.456)	(0.878)	(0.903)	(0.008)	(0.017)	(0.425)	(0.377)
Credit *variable 1/			-0.084	-0.444	-0.016	0.100	**-0.005** **	-0.013	**-0.131*** **	0.006
			(0.155)	(0.424)	(0.058)	(0.130)	(0.002)	(0.009)	(0.039)	(0.267)
Observations	321	321	321	321	321	321	321	321	321	321
R-squared					0.72					
No. of groups	96	96	96	96		96	96	96	96	96
No. of instruments	64	64	67	67		67	77	77	67	67
Hansen test p-value	0.357	0.337	0.302	0.267		0.283	0.747	0.448	0.546	0.388
A-B AR(2) test	1.191	1.075	1.236	1.152		0.891	1.026	1.427	1.012	1.075
A-B AR(2) test p-value	0.234	0.282	0.216	0.249		0.373	0.305	0.154	0.311	0.282

Source: Authors' calculations.

Notes: Robust standard errors in parentheses. *** Coefficient significant at the 1 percent level; ** at the 5 percent level; * at the 10 percent level
Dependent variable is the ratio of liquid assets to total assets. GMM is two-step system GMM estimator with Windmeijer standard error correction.
Columns (3) through (10 test the hypotheses that ownership (foreign/domestic and public/private), degree of dollarization and coverage of the financial safety net affect banks
Ownership is captured by dummy variables (=1 if the bank is private, =1 if the bank is foreign), dollarization by the share of dollar deposits in total deposits at the country lev
All regressions include time and country dummies. Constant estimated but not reported.
1/ Credit is captured either by a measure of credit institutions, proxied by the principal components analysis of the Doing Business variables measuring the quality of credit institutions. Financial depth is proxied by the credit-to-GDP ratio.

Appendix IV. Table 2. Determinants of Banks' Liquidity Buffers in CAPDR - GMM Estimates (unless otherwise specified)

Dependent variable is the ratio of liquid assets to customer deposits and short-term funding	Baseline 1/			Foreign ownership 2/		Dollarization 2/		Safety net 2/	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Pooled OLS	GMM	Fixed Effects	Credit Institutions	Financial Depth	Credit Institutions	Financial Depth	Credit Institutions	Financial Depth
Liquid assets ratio (-1)	0.347***	0.189***	0.169***	0.171**	0.164**	0.256***	0.227***	0.252***	0.221***
	(0.064)	(0.044)	(0.025)	(0.070)	(0.069)	(0.074)	(0.072)	(0.083)	(0.063)
Bank size	7.401***	7.994***	16.804	9.227*	11.172**	7.615**	7.848**	8.551***	8.543***
	(1.448)	(1.875)	(10.703)	(4.806)	(5.221)	(2.972)	(3.038)	(2.081)	(2.126)
Bank size squared	-0.350***	-0.371***	-0.886*	-0.469**	-0.553**	-0.362**	-0.381**	-0.410***	-0.414***
	(0.064)	(0.092)	(0.476)	(0.204)	(0.218)	(0.150)	(0.152)	(0.107)	(0.106)
Capitalization	-0.355***	-0.321**	-0.502***	-0.711	-0.453	-0.281	-0.424	-0.386	-0.262
	(0.060)	(0.123)	(0.184)	(0.557)	(0.516)	(0.495)	(0.477)	(0.528)	(0.457)
Net interest margin	-0.156**	-0.123	0.011	-0.774	-1.169	0.452	0.332	-0.056	-0.107
	(0.064)	(0.076)	(0.325)	(0.752)	(0.833)	(0.276)	(0.335)	(0.704)	(0.706)
Loan-loss reserve ratio	-0.224	-0.282	0.221	-0.448	-0.984	-1.071	-1.032	1.536	1.277
	(0.160)	(0.252)	(0.290)	(0.553)	(0.810)	(0.678)	(0.704)	(1.691)	(1.627)
Credit 3/	-0.213	-0.323	-0.337*	0.044	-0.904**	0.240***	-0.860	0.625**	-0.123
	(0.272)	(0.292)	(0.199)	(0.046)	(0.387)	(0.088)	(0.675)	(0.250)	(0.794)
Variable				-6.238	-18.363	**0.666****	**1.201*****	**27.313****	-10.493
				(12.128)	(15.445)	(0.293)	(0.412)	(13.739)	(35.604)
Capitalization*variable				0.339	-0.070	-0.001	0.000	-0.037	-0.092
				(0.608)	(0.711)	(0.007)	(0.008)	(0.191)	(0.164)
Net interest margin*variable				0.441	0.973	**-0.025****	-0.021	-0.023	-0.000
				(0.750)	(0.891)	(0.012)	(0.015)	(0.217)	(0.218)
Loan-loss reserve ratio*variable				2.167*	**3.021***	0.042*	0.036	-0.429	-0.339
				(1.222)	(1.552)	(0.021)	(0.022)	(0.549)	(0.451)
Credit to GDP ratio*variable 1/				0.010	0.212	**-0.008****	-0.003	**-0.169****	-0.231
				(0.091)	(0.214)	(0.003)	(0.009)	(0.070)	(0.262)
Observations	321	321	321	289	289	289	289	289	289
R-squared	0.55		0.19						
No. of groups		96	96	88	88	88	88	88	88
No. of instruments	.	64		67	67	77	77	67	67
Hansen test p-value		0.348		0.105	0.117	0.135	0.135	0.187	0.243
A-B AR(2) test		1.283		1.262	0.770	1.600	1.574	1.231	1.322
A-B AR(2) test p-value		0.199		0.207	0.442	0.110	0.116	0.218	0.186

Source: Authors' calculations.

Notes: Robust standard errors in parentheses. *** Coefficient significant at the 1 percent level; ** at the 5 percent level; * at the 10 percent level
Dependent variable is the ratio of liquid assets to customer deposits and short-term funding. Two-step system GMM estimator with Windmeijer standard error correction.
Ownership is captured by dummy variables (=1 if the bank is private, =1 if the bank is foreign), dollarization by the share of dollar deposits in total deposits at the country level. Safety net is an index variable categorizing the existence of each of the 4 components of a safety net in each country (Appendix II. Table 1).
All regressions include time and country dummies. Constant estimated but not reported.
1/ Columns (1) and (2) as in Table 4a. Column (3) reports results of the fixed effects estimation.
2/ Columns (4)-(9) show GMM estimation results for the sample of private banks (excluding public banks).
3/ In columns (1)-(3) credit is captured by a measure of financial depth, proxied by the credit-to-GDP ratio. In columns (4)-(9), Credit institutions are proxied by the principal components analysis of the Doing Business variables measuring the quality of credit institutions.