Box 1

CENTRAL AMERICA AND THE DOMINICAN REPUBLIC: MONETARY POLICY AND BANKING SECTOR DEVELOPMENTS

Monetary policy

Faced with rising inflation in Central America and the Dominican Republic (CADR),[1] most of the regions' central banks tightened monetary policy in 2022. Costa Rica saw the most aggressive increase in policy rates, which were hiked from 1.75% to 9% between January and December 2022. By contrast, Guatemala, Nicaragua and the Dominican Republic raised their policy rates more modestly, and Honduras left them unchanged (see Chart 1).

Two countries began to reduce their policy rates in 2023. Costa Rica's policy rate was cut by 150 basis points (bp)

Chart 1
Monetary policy rate (a)

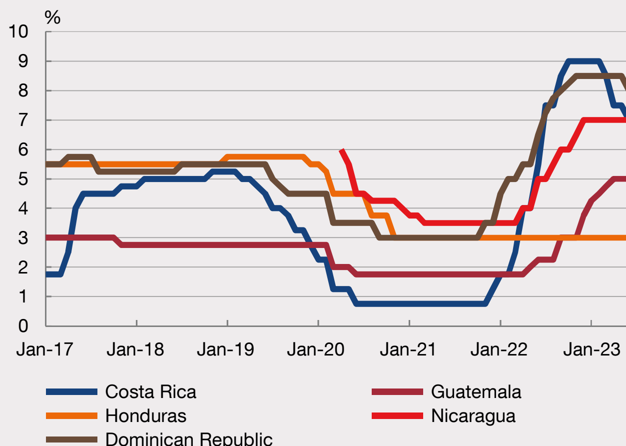


Chart 2
Monetary aggregate M1

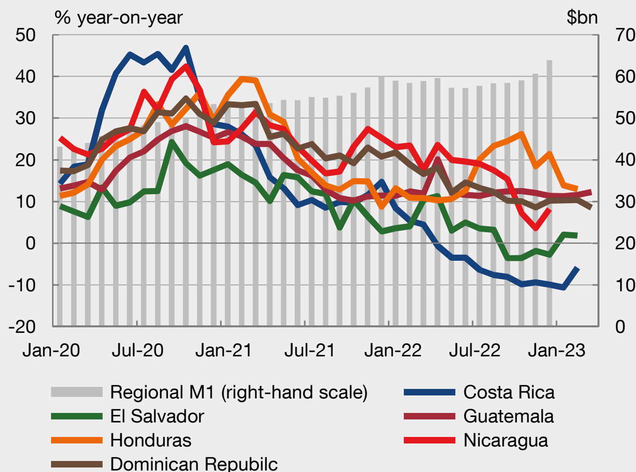


Chart 3
Liquidity indicator for banking systems in the region (b)

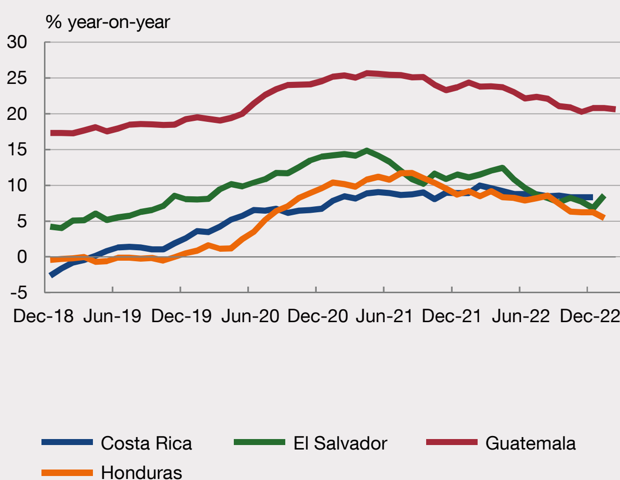
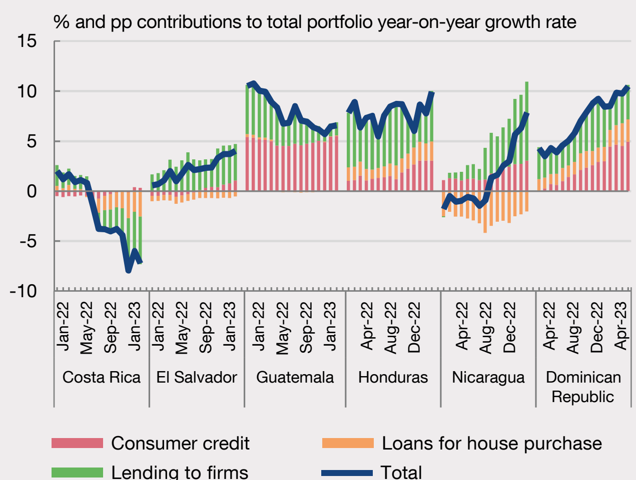


Chart 4
Growth rate of total lending and contribution to growth disaggregated by purpose for other deposit institutions



SOURCE: Secretaría Ejecutiva del Consejo Monetario Centroamericano.

a Costa Rica, Guatemala, Honduras and the Dominican Republic have a monetary policy rate. The monetary repo reference rate is used for Nicaragua.
b The liquidity indicator is calculated as the result of dividing the difference between deposits and lending by banking system assets.

1 The countries comprising CADR (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic) are generally considered together since they have a shared institutional framework to deepen their trade and financial integration.

Box 1

CENTRAL AMERICA AND THE DOMINICAN REPUBLIC: MONETARY POLICY AND BANKING SECTOR DEVELOPMENTS (cont'd)

(50 bp in March and 100 bp in April), while the Central Bank of the Dominican Republic cut its policy rate by 50 bp in late May. The change in these two countries' monetary policy stance is mostly attributable to the long-standing downward trend in their rates of inflation. In Nicaragua, policy rates have remained unchanged, while in Guatemala the policy rate has continued to rise in 2023 (from 3.75% to 5%) as part of a strategy which seeks to drive inflation towards its target without significantly hampering its economic buoyancy.

Liquidity

Restrictive monetary policies in all CADR countries have dampened growth in their most liquid monetary aggregates (M1). The slowdown correlates negatively with interest-rate changes. Thus, M1 fell most in Costa Rica, whereas the decline in El Salvador (the region's only dollarised economy) was relatively small (see Chart 2).

In Guatemala, the Dominican Republic and Nicaragua – countries that have seen relatively modest tightening of the monetary policy – M1 growth has steadily eased, especially from 2022 Q2 onwards. In Honduras, by contrast, where the policy rate is unchanged, M1 growth slowed from 2022 Q3 onwards as a result of the central bank using open market operations.

The pace of bank deposit growth has slowed throughout the CADR region, although the level of bank deposits remains high owing to their strong momentum during the pandemic years, which was driven by the increase in household savings and firms' and households' greater preference for liquidity. Together, the above factors mean that banking systems throughout the region enjoy comfortable liquidity positions (see Chart 3).

Credit

CADR banking systems have high liquidity levels and adequate solvency levels. With the exception of Costa Rica, earnings have enjoyed a strong recovery after being hard hit by the pandemic-related crisis.

Real credit growth in Guatemala, Honduras and the Dominican Republic has exceeded 5% since 2022 Q3. By component, Guatemala's strongest growth comes in the consumer credit segment, with rates around 13%. In Honduras and the Dominican Republic, all credit components are highly buoyant, although the consumer credit segment has picked up pace in recent months. Lending to firms has gained ground in El Salvador, while in Nicaragua the total lending portfolio has expanded since 2022 H2, driven by both lending to firms and consumer credit (Chart 4). In Costa Rica, the credit portfolio has generally shrunk, although, based on the most recent data, the rate of deceleration appears to have fallen in line with changes in the country's monetary policy stance.

The quickening pace of credit growth observed in most of the region's countries comes in spite of tighter monetary policies both domestically and worldwide, indicating that other reasons lie behind the change. Transmission of monetary policy to lending depends on financial depth. Thus, monetary policy may have a greater effect on Costa Rica than on the rest of the CADR because financial depth, measured as the credit-to-GDP ratio, is approximately 50%, higher than levels in Guatemala, the Dominican Republic and Nicaragua, which stand at around 37%, 21% and 26%, respectively. However, it is likely that the pandemic has shifted the region's financial structure, changing the transmission mechanism of monetary policy to lending. For instance, in those countries with relatively less financial depth (particularly Guatemala and the Dominican Republic), the lockdown had significant consequences for financial inclusion, thus altering long-run trends in lending. In Nicaragua, credit growth is the result of the economic recovery in the wake of a deep recession triggered by political factors in 2018. In addition, CADR countries saw an uptick in remittances during and after the pandemic, particularly from the United States, which, given the mobility restrictions, were routed through formal channels, thereby enabling a structural change in the financing sources for intermediation.