

# Comments on “Foreign banks and credit conditions in EMEs”

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## Summary

The definition and measurement of “foreign” credit in empirical analysis is often ambiguous, but it matters both for understanding the role of foreign credit flows in the domestic economy and the potential implications for policy.

This paper does a service by clearly defining and analysing the following four definitions of foreign credit as a share of total domestic plus cross-border bank credit:

- (1) the narrowest one is credit from banks abroad lent directly to local companies and households (the real economy);
- (2) a wider definition of foreign bank lending, often used in BIS papers, adds to measure 1 cross-border bank credit to domestic banks, including both locally headquartered banks and the affiliates of foreign headquartered banks, to fund, *inter alia*, their own lending to the domestic real economy;
- (3) a broad measure of foreign-owned banks’ direct credit to local companies and households (ie, direct cross-border bank credit (measure 1) plus an estimate of credit from local affiliates of foreign-owned banks), which is called “foreign participation” and is the main data innovation in the paper; and
- (4) a definition based on the currency rather than bank ownership of “foreign” credit provided that includes foreign currency credit from domestic headquartered banks as well as from foreign headquartered ones.

These four measures of credit are often highly correlated – rising in many emerging market economies (EMEs) before the Great Financial Crisis (GFC) of 2007–09 and falling thereafter. That said, for most EMEs the foreign participation measure shows the largest foreign credit share depending on the extent to which foreign affiliates lend in local currency and are funded from domestic deposits rather than from abroad.

The main empirical results of the paper relate to the role of foreign credit in EMEs contributing to the increase in total bank credit (relative to GDP) to the real economy before 2008 and in causing a slowdown in GDP growth in the wake of the GFC. The authors find that differences in the growth of the share of direct cross-border bank credit (measure 1) play the most significant role in explaining differences in the growth of total credit to the domestic economy across EMEs in the 2002–08 period, and that differences in the share of direct cross-border credit at the outset of the crisis in 2008 explain differences in GDP growth afterwards (2008–10). However, credit from locally based foreign affiliates is found to temper the pre-crisis credit boom, and their turnaround was less evident than other measures of “foreign” credit in contributing to the post-crisis slowdown in growth. The authors attribute the latter

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finding to foreign affiliates funding a lot of their local lending from local deposits that were a relatively stable form of financing pre- and post-GFC.

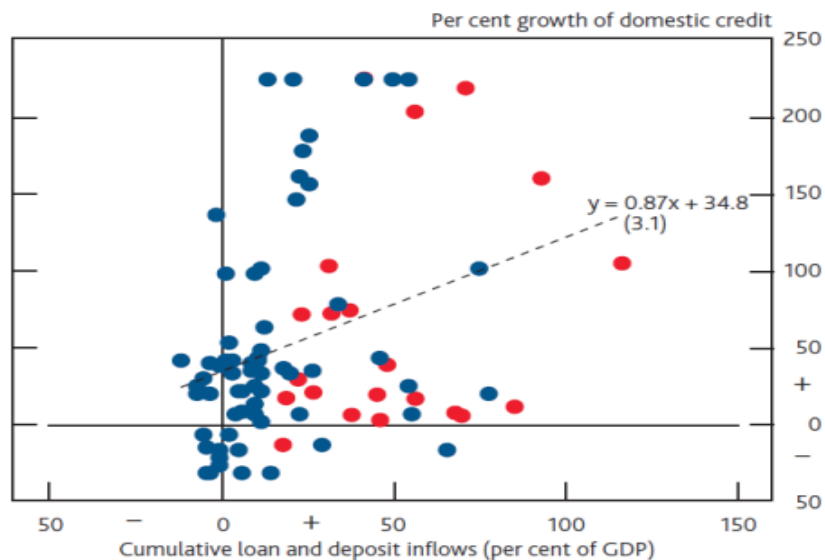
The second main contribution of the paper is that the authors go on to attempt to identify whether changes in foreign credit are driven by supply or demand factors. Supply falls if a particular foreign banking system reduces credit to all EMEs, whilst at the other extreme, “demand” falls if all foreign banking systems reduce their credit to one EME.<sup>2</sup> Using this approach, they find that in the wake of the GFC, many EMEs faced a reduction in supply from foreign banks, especially from European ones. Working in the other direction, the fall in the growth of foreign credit to China in recent years (2014–15) is interpreted mainly as a demand shock, since lending from foreign banking systems fell there more than in other EMEs.

## Comment

The paper usefully highlights the role of different measures of foreign credit and especially the procyclical role played by cross-border credit. This is consistent with most previous empirical studies that show that bank lending is the most volatile form of capital inflows.<sup>3</sup> We have also found this pattern for advanced countries as well as for EMEs. Graph 1 shows that in the run-up to the GFC in countries where cross-border credit grew the most, so too did domestic credit. This combination was more likely associated with a financial crisis during the GFC highlighted by the red dots in the chart.

Growth of domestic credit and cumulative direct cross-border bank credit (end-2002–end-2007) and crisis incidence in the subsequent two years<sup>1</sup>

Graph 1



<sup>1</sup> A red dot indicates that the country experienced a banking crisis in 2008–10. A blue dot indicates no crisis. Data on banking crises were obtained from Laeven and Valencia (2013).

Source: Hoggarth et al (2016).

<sup>2</sup> The term used in the paper is demand shock.

<sup>3</sup> See, for example, Kose et al (2009) and Forbes and Warnock (2012).

One of the most interesting results in the paper is that where foreign affiliates accounted for a bigger share of credit to the real economy in EMEs, this tended to temper credit booms before the global crisis.

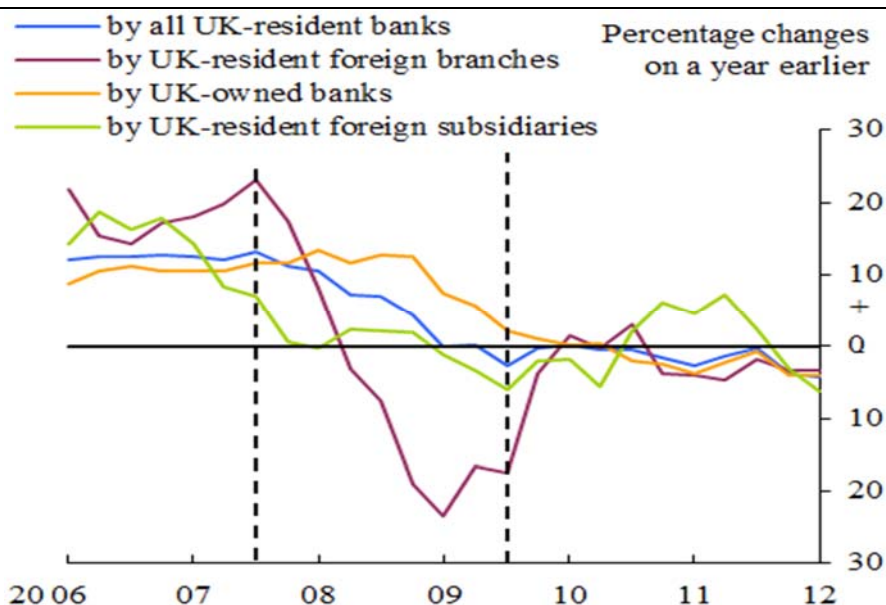
In future work, it would be useful to investigate this result in more detail. One approach would be to also explicitly include domestic credit from locally headquartered banks in the equations, so there is a direct comparison between foreign- and domestic-owned banks in contributing to domestic credit booms and the subsequent slowdown in GDP growth.

It would also be very useful to know whether the credit smoothing role found for foreign affiliates as a whole applies to both foreign subsidiaries and branches. This is important from a policy perspective given that the local regulator has more supervisory powers over foreign subsidiaries that are local legal entities than it does over foreign branches which are part of the foreign-headquartered banks.

In the United Kingdom, the growth in credit from foreign subsidiaries was much less cyclical than from foreign branches pre- and post-GFC (Graph 2; compare the green and mauve lines). In fact, the amplitude in the credit growth cycle from foreign branches was similar to that of direct cross-border bank credit. Similarly, recent studies of the US (Goulding and Nolle (2012)) and Italian (Albertazzi and Bottero (2013)) banking systems found that the domestic credit cycle was greater for foreign branches than for either domestic-owned banks or foreign subsidiaries.

Annual growth in bank lending to the UK private sector

Graph 2



Source: Hoggarth et al (2013).

The sharp decline in credit to the UK domestic economy from foreign branches in the wake of the GFC was, we think, due to a combination of supply and demand factors. On the supply side, 70% of the liabilities of foreign branches were from abroad, especially from banks, particularly from the parent bank. In contrast, three-quarters of funding of foreign subsidiaries was from domestic deposits. Given that the centre of the crisis was the international banking system rather than domestic households and companies, wholesale funding was less stable than retail funding.

Also, on the demand side, most domestic lending in the United Kingdom by foreign branches was to the financial sector rather than to domestic companies and especially households.

On the identification of credit supply versus demand, the latter should be regarded as a country-specific shock since it affects lending by foreign banking systems to a specific EME borrower. This could capture a range of “pull” factors rather than necessarily a change in demand for credit from an EME’s final households and corporates. That said, as a check on the identification of (country-specific) credit demand versus (banking system-specific) supply, it would be useful to compare the pattern of credit growth from foreign banks with credit from international bond markets. If there was a foreign bank credit supply shock, then there would be an expected negative correlation with credit from banks and from market finance as non-bank financial institutions stepped in and took up the unsatisfied demand. On the other hand, if there was a country-specific shock, then credit would also be expected to fall from these other foreign lenders.

Another reason to expand the analysis to foreign debt market finance is that portfolio debt flows to EMEs have become more important since the GFC, especially when including the debt issued abroad by the affiliates of EME-headquartered companies (see, for example, McCauley et al (2015)).

Usually cross-border bank credit to EMEs is thought to be volatile and thus pose domestic funding risks. This is confirmed by the results in this paper. However, the balance sheet risk may be bigger with portfolio debt since nearly all this debt is in foreign currency, whereas cross-border bank credit has increasingly been provided in domestic currency. Moreover, portfolio debt is mainly issued to global institutional investors, which tend to be less regulated than international banks.

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