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International spillovers from Euro area and US credit and demand shocks: A focus on emerging Europe ☆

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ABSTRACT

In this paper, we examine the international effects of contractions in loan supply, loan demand and aggregate demand in the euro area and the USA. All three shocks have been at the forefront in spreading stress during the period of the global financial crisis and in particular so to countries that are strongly integrated with the euro area. We find that these shocks decrease international output and total credit to a varying degree. Loan demand and aggregate demand shocks in the euro area trigger significant negative spillovers on output in most other regions. Evidence for global negative output effects of euro area loan supply shocks is fraught with considerable estimation uncertainty. When these three types of shocks emanate from the USA, we find significant negative spillovers on output also for loan supply shocks. In general, international effects on total credit are an order of magnitude larger than those on output, with again more evidence that is significant for US than euro area shocks. Last, and taking a regional stance, our results indicate that economies from emerging Europe are most vulnerable to all shocks considered. Through their strong economic integration with the euro area, these economies are likewise exposed to euro area and US shocks, and spillover effects are often larger than the domestic response in the country of shock-origin.

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1. Introduction

When the financial crisis erupted in 2008, the global economy witnessed a collapse in trade followed by a sharp contraction of real activity. In its aftermath, financial and economic conditions were characterized by tightened credit, increasing loan loss provisions and a lack of confidence between banks (Busch et al., 2010). On the one hand it was argued that the decrease in new lending was driven by a sharp reduction in the demand for loans. On the other hand, banks were blamed to have tightened credit standards, being overly reluctant to engage in new lending as a part of cleaning their balance sheets. These effects have certainly contributed to the sharp drop in international real activity witnessed during the period of 2008–2009. However, countries not directly affected by shocks to credit saw their output deteriorate facing adverse aggregate demand shocks for their exports and/or a surge in risk averseness of international investors triggering a kind of “flight to safety” redirection of their investment (Chudik and Fratzscher, 2011). From a policy perspective, the distinction between supply driven and demand driven shocks to credit lending and other macroeconomic shocks, such as adverse aggregate demand, is important since they might call for very different responses of monetary and fiscal policy (Gambetti and Musso, 2012).

In this paper we investigate *spillovers* from euro area and US shocks. Both economies have been at the core of recent episodes of macrofinancial stress, the sovereign debt crisis (the euro area) on the one hand, and the global financial crisis (the USA) on the other hand. We examine three shocks in more detail that have been vital in spreading stress recently, namely adverse loan supply and demand shocks and – more generally – a negative shock to aggregate demand. For that purpose we use a global vector-autoregressive (GVAR) model that was put forward among others in Pesaran et al. (2004), Dees et al. (2007a,b), Garratt et al. (2006), and extend it to feature total credit and countries from Central, Eastern and Southeastern Europe (CESEE), and the Commonwealth of Independent States (CIS). To a different degree, these countries share strong trade and financial linkages – either in the form of direct cross-border loans to the non-financial sector, wholesale funding or intra-group parent bank funding to the banking sector – with the euro area. Including these countries in a study to assess adverse shocks to credit supply in the euro area seems thus essential and provides a new angle on the strength and transmission of financial shocks in general and during the crisis. Finally, our analysis separates loan supply, loan demand and aggregate demand shocks from other macroeconomic shocks by explicitly controlling also for disturbances from aggregate supply and monetary policy. This yields a comprehensive assessment of macroeconomic fluctuations of a broad range of economies with different degrees of financial and trade integration with the world economy.

Our general results are as follows: We find evidence that output and total credit decline in response to the credit-related and aggregate demand shocks. Global negative effects on output are significant for all regions (in Asia partly in the short-term only) following a loan demand or aggregate demand shock in the euro area or the USA. By contrast, negative output effects of loan supply shocks are significant for all regions except for Latin America (in the medium- to long-run) and for Asia if these shocks emanate from the USA, and are fraught with estimation uncertainty if these are euro area shocks. Moreover, regarding total credit, it turns out that more regions are significantly affected by US shocks compared to euro area shocks. Second and taking a regional stance, the high degree of economic integration with the euro area renders CESEE and CIS economies most vulnerable to euro area macrofinancial shocks. Through knock-on effects, mostly via the euro area, both regions are also strongly exposed to US shocks. This is also demonstrated via a historical decomposition analysis which shows that US shocks contributed strongly in explaining deviations from trend growth in output and

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