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Testing the global banking glut hypothesis

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ABSTRACT

This paper presents VAR results on the recent economic history of the U.S. and focuses on the dependence of U.S. macrofinancial variables on international capital flows. Both gross and net flows are included in the analysis. The results indicate that cross-border funding has affected the build-up in the U.S. housing market irrespective of how these flows are defined and measured. Both the savings glut hypothesis and the banking glut hypothesis are supported by these findings. However, net banking flows appear to explain the higher volatility in the increase in house prices as well as the mortgage loan boom.

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1. Introduction

In this paper, we focus on the recent boom in U.S. house prices and mortgage loans. Many authors have argued that the surging capital flows into the U.S. contributed to the run-up in house prices and mortgage loans.[1] We focus on different types of capital flows, distinguishing between acquisitions of government and corporate assets. The recent literature has highlighted the different role played by gross and net inflows in explaining the credit boom. In particular, Shin (2012) suggests that the easy credit conditions in the U.S. were due to gross cross-border positions rather than net capital flows. Following this line, we also distinguish between gross and net flows in explaining the U.S. housing and credit boom.

Since Ben Bernanke's (2005) speech addressing global imbalances, it has been argued that current-account imbalances were a key factor leading to the permissive financial conditions in the U.S. during the "great moderation". Bernanke (2005, 2007) presented the global savings glut hypothesis by stating that the excess supply of savings relative to investments in surplus countries was channeled into deficit countries, such as the U.S., which fundamentally affected credit conditions. Caballero and Krishnamurthy (2009) presented a model to explain how foreign demand for safe USD-denominated assets moved the U.S. financial system into advanced financial engineering in respect of mortgage processing, in order to create the low-risk assets demanded by foreigners and to keep a levered claim on domestic debt. This financial engineering made it possible to use loans of dubious quality as raw material for highly rated securities. This in turn had substantial macroeconomic effects: capital flows from emerging markets made credit cheap and fuelled the asset price boom (see e.g. Bernanke (2010), Bertaut et al. (2012)).

Fig. 1, first row, plots HP-filtered data for real house prices, mortgage loans and the current account deficit of the United States. Mere "eyeball econometrics" suggests that these three variables are strongly linked and consistent with the savings glut hypothesis. Sá et al. (2014) and Sá and Wieladek (2015) found that capital inflow shocks have a significant effect on house prices, which corroborates the savings glut hypothesis.[2] Spain and

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[1] See Bernanke (2005), Towbin et al. (2012), Ferrero (2012), Mendicino and Punzi (2014).

[2] Punzi (2013) shows a different causality by studying the link between house price increases and current account deficits through the lens of a dynamic stochastic

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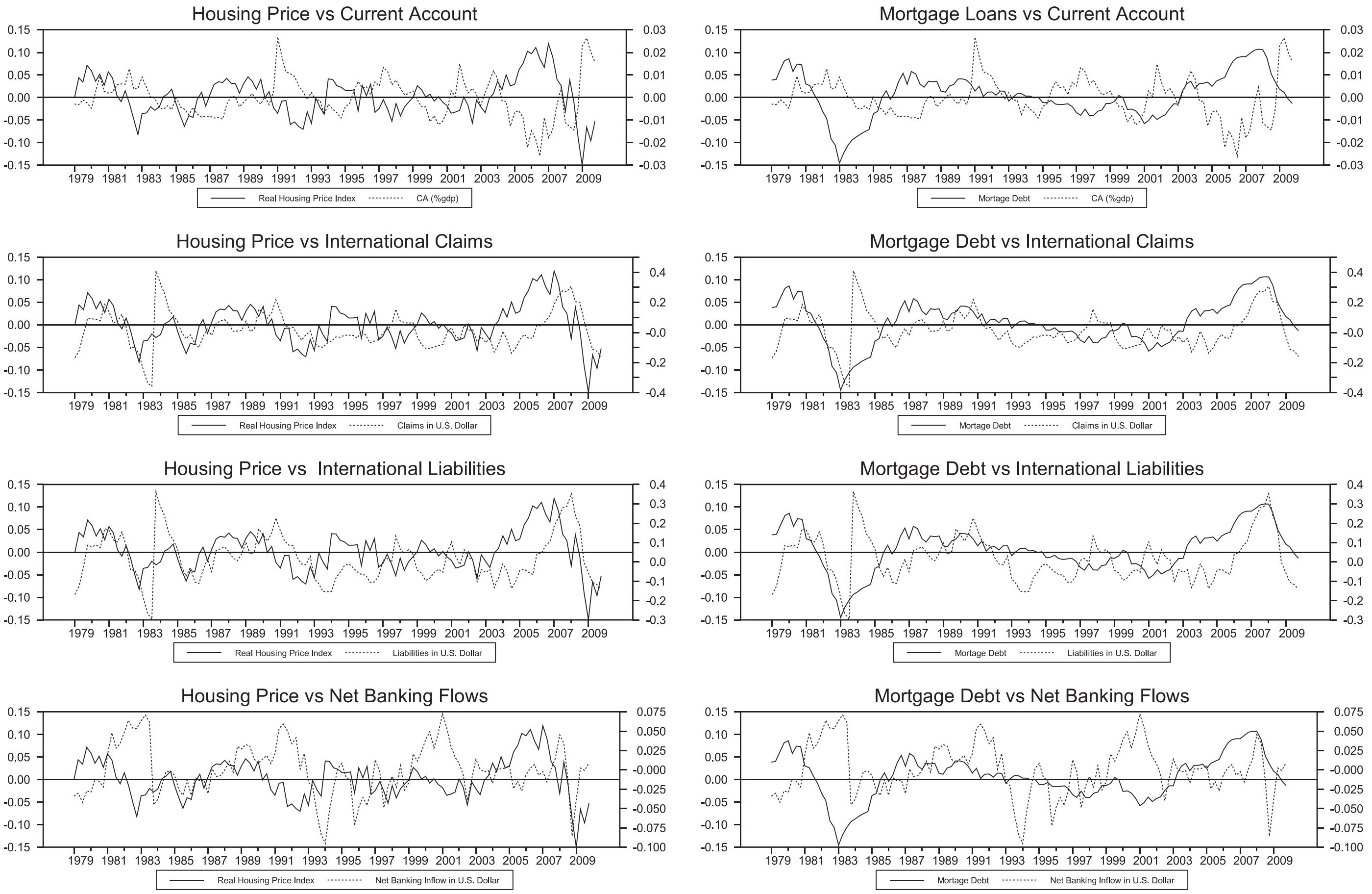

Fig. 1. Data.

Ireland are other excellent examples of countries where the inflow of foreign funding occurred simultaneously with a house price bubble.[3]

However, an alternative hypothesis shows that different sources of international financial flows have affected credit conditions in the U.S. economy, particularly emphasizing the role of gross flows relative to net flows. Acharya and Schnabl (2010) and Shin (2012) argue that banks outside the U.S. were investing large amounts of funds in long-term U.S. assets before the 2007 financial crisis, suggesting that the global saving glut hypothesis is meaningless relative to the role of foreign banks. As pointed out by Borio and Disyatat (2011), substantial gross inflows of investments came from Europe, rather than China or oil exporting Arab countries.[4] Bertaut et al. (2012) found that countries running current account surpluses affect credit conditions by lowering long-term yields on US Treasury securities. As a result, European investors substitute Treasury assets with private securities, as they seek higher yields. The role of European banks is not evident in the current account statistics because the net difference between debts and receivables is small; financing was acquired in the very same market where the loans were granted.[5] Fig. 2 compares data for 2003 and 2007, revealing that while surplus countries have been accumulating U.S. assets, these purchases have consisted almost exclusively of Treasury and Agency bonds. Europeans have shown a preference for holding larger shares in AAA-rated asset-backed securities (including private-label MBS), equities and lower-rated debt.[6]

Shin (2012) introduced the global banking glut hypothesis, which emphasizes the global excess supply of banks' financial intermediation capacity. He presented both statistical evidence on the growing role of European banks in the U.S. and a formal model on how excess financial intermediation capacity could affect credit conditions. As pointed out by Shin (2012), the introduction of the Basel II capital adequacy system in the EU enabled European banks to expand their balance sheets overseas by freeing up bank capital

general equilibrium model. Her model shows that increasing housing demand pushes the U.S. economy to borrow from abroad.

[3] Most of the countries with massive net inflows of foreign funding were hit particularly hard by the international financial crisis (Aizenman and Pasricha, 2012), Kauko (2012)), consistent with the “capital bonanza” hypothesis of Reinhart and Reinhart (2008).

[4] Benhima (2013) shows that some countries, including China, suffer from a misallocation of capital and invest only in short-term projects. As financial markets integrate, emerging countries gain more access to cheaper short-term assets abroad, leaving them with more resources to invest in long-term projects at home.

[5] European banks raised wholesale funds from their affiliates in the United States. Via their head offices and/or financial centres, they lent those funds back to non-banks in the United States or in other countries, either directly or by funding local banks.

[6] Because of the depreciation in the U.S. dollar against the euro and because the U.S. supply of new financial assets (i.e. mortgage backed securities), European banks have intensively expanded their balance sheets in the U.S. and elsewhere through their foreign branches.

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