ARTICLE IN PRESS

Research in International Business and Finance xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

ELSEVIER

Full length Article

Determinants of the domestic credits in developing economies: The role of political risks

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ARTICLE INFO

JEL classification:
E51
F44
C33

Keywords:
Credit growth
Emerging markets
Political risks
Sustainable development of the financial sector
Panel data estimation techniques

ABSTRACT

This paper examines the determinants of the domestic credits in the panel data of 61 developing economies (22 emerging markets and 39 non-emerging developing economies) for the period from 1984 to 2016. The paper finds that the income and the money supply are positively associated with the domestic credits. There also are the negative effects of the current account balance and the interest rate differences on the domestic credits. Further analyses for the subcomponents of the overall political risk measures indicate that the better socioeconomic conditions (i.e. the less poverty, the lower unemployment, and the higher consumer confidence) and the lower corruption positively affect the domestic credits.

1. Introduction

Analyzing potential determinants of the level of domestic credit has been an active research field since the early 2010s. This is mainly due to the evidence that many emerging markets have experienced significant "credit boom-bust cycles" during the last decade (see, e.g. Anderson et al., 2017). It is also important to understand potential determinants of credit levels since it can directly affect the welfare in developing economies (Obstfeld, 2012). Domestic credit growth has also been a leading driver of the economic growth in many emerging economies, especially since the early 1990s (Samargandi and Kutan, 2016). In today's world, domestic credit growth is not only the engine of the investments but also it is the main source of the household consumption, especially in developing economies. To this end, our paper aims to analyze the determinants of the levels of domestic credits in 61 developing economies, including 22 emerging markets and 39 non-emerging developing economies, for the period from 1984 to 2016. A special role is given to the effects of the political risk indicators as the potential determinants of the domestic credit growth.

Understanding the determinants of domestic credit growth is also noteworthy due to several reasons. First, domestic credit growth is a leading early-warning indicator for predicting the financial crisis. For example, according to Montoro and Rojas-Suarez (2012), the level of the domestic credits can affect the financial stability and the macroeconomic stance, and it has been the main driver of the banking and the borrowing crises in the Latin American countries and Mexico during the 1990s. In addition, the several papers have recently shown that domestic credit growth was also the significant early-warning indicator for predicting the global financial crisis of 2008–9 (see e.g. Davis et al., 2016; Dell'Ariccia et al., 2016; Gourinchas and Obstfeld, 2012; Jordá et al., 2011, 2016; Lane and McQuade, 2014; Schularick and Taylor, 2012). According to these papers, when there is a sharp reduction in the level of domestic credits, this causes to a slower economic activity, and then, it distorts the financial stability, especially in the developing economies. For instance, Gourinchas and Obstfeld (2012) observe that the relative strength of emerging markets during the global crisis of 2008–9 was associated with their avoidance of domestic credit booms in the previous years. According to Gourinchas and Obstfeld

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https://doi.org/10.1016/j.ribaf.2018.05.002
Received 18 July 2017; Received in revised form 30 April 2018; Accepted 10 May 2018

Please cite this article as: Gozgor, G., Research in International Business and Finance (2018), https://doi.org/10.1016/j.ribaf.2018.05.002

(2012), this has not been experienced in the developing Central and Eastern European economies, and that's why the consequences of the global crisis were quite devastating across the region.

The second issue can be defined as the "credit-driven bubble". According to Mishkin (2010), the global financial crisis of 2008–9 has also illustrated that domestic credits can lead to an asset price bubble (house price bubble in particular). The collapse of the bubbles can also negatively affect the macroeconomic stance and the financial stability in many developing economies.

The third issue of the effects of the domestic credits can be defined as the "direct effect". According to Luca and Spatafora (2012), the domestic credits are the main source of both the investments of the private sector and the government enterprises; and therefore, the domestic credits can directly affect the macroeconomic activity in developing economies.

The fourth issue can be defined as the "substitution effect": Domestic credits are the substitute of the external borrowing in developing economies. To put it differently, when the banks stall the loan facility to the private sector, domestic firms will try to borrow from abroad to finance their investments. This issue can create a pressure on the exchange rate and can bring an extra "exchange rate risk" to the firms, especially during the periods of speculative attacks. According to Obstfeld (2012), the feasibility of borrowing from abroad depends on financial openness and a higher level of financial openness allows developing economies to borrow at the lower interest rates. In addition, borrowing at the lower interest rates creates a less pressure on the exchange rate, and thus the inflation rate. Therefore, the interest rate difference between the domestic funding and the foreign funding also drives the domestic credit growth in developing economies. In short, domestic credit may be driven by various factors and it can significantly affect various indicators in a small open-economy. To this end, the goal of our paper is to analyze the potential determinants of domestic credit growth in the panel dataset of 61 developing economies.

Indeed, there is a rapidly developing literature for analyzing potential drivers of the domestic credits in developing economies; however, potential determinants of domestic credits remain unclear and seem to be complex (Elekdag and Han, 2015). In this paper, we analyze not only the effects of financial and macroeconomic indicators for the domestic credits, but also control for the measures of the political risks in the empirical models. At this stage, political risks can also affect the level of domestic credits in various ways. On the demand side, the socioeconomic conditions (the consumer confidence, poverty, and unemployment) can affect the demand for credits of the household. Another significant aspect of the demand for credits comes from the business world. The business world can postpone their investments during the times of the higher political risks (e.g. the periods of government instability, internal and external conflicts, ethnic and religious tensions, and significant intervention of the military in politics); and therefore, these aspects of political risk can negatively affect the demand for credits (Rios-Morales et al., 2009). There are also the supply-side of the domestic credits and a higher level of political risks can also negatively affect the supply of credits. For example, the higher quality of institutions (e.g. the higher levels of bureaucracy quality, democratic accountability, investment profile (enforcement of contracts), and law and order (rule of law) and a lower level of corruption) can positively drive the domestic credits. At this stage, various political risk components can be important in different subgroups of developing economies since our data focus on the domestic credits across a wide range of 61 developing economies. Given that those countries can be affected by the different aspects of political risks, one should expect the different effects of political risk components in emerging markets compared to the non-emerging developing markets. Overall, our paper tests the validity of the hypothesis whether the higher level of overall political risks negatively affects the domestic credits in 61 developing economies.

To the best of our knowledge, our paper is the first study to analyze the direct effects of the political risk measures on the level of domestic credits across a wide range of 61 developing economies. In addition, we further examine the cases of 22 emerging markets and 39 non-emerging developing economies. We control various internal and external economic and financial indicators in the empirical models. We also consider several panel data estimation techniques to obtain economically and statistically robust evidence. Our results show that there is the negative effect of the overall political risk on the domestic credits, and the effect is greater in the emerging markets than the non-emerging developing economies. Further analyses for the subcomponents of the overall political risk measures indicate that both the better socioeconomic conditions (i.e. the less poverty, the lower unemployment, and the higher consumer confidence) and the lower corruption positively affect the domestic credits.

The remainder of the paper is organized as follows. Section 2 reviews the empirical literature on the determinants of the domestic credits in developing economies. Section 3 explains our model, data, and econometric methodology. Section 4 reports the empirical findings and discusses the implications. Section 5 provides the robustness checks and the sensitivity analysis. Section 6 concludes.

2. Literature review

Understanding main variables, which determine the level of domestic credits in developing economies, is an active research area and the number of papers has been increased since the global financial crisis of 2008–9. For example, Hume and Sentence (2009) show that the booms of the domestic credits are associated with the monetary policy (the money supply) and the macroeconomic policy risk perceptions (the current account balance) rather than the strong economic growth or the inflation rate. Bakker and Gulde (2010) analyze the boom-and-bust cycles of the domestic credits in nine new European Union (EU) members and observe that the external factors called as the "bad luck" and the inflation rate are among the leading determinants of the credit cycles across the region. Takats (2010) also shows that the gross domestic product (GDP) (main demand factor) and the volatility of the S&P 500 index (main supply factor) are the main drivers of the cross-border bank lending in 21 emerging markets for the period from 1995 to 2009. Similarly, Borio et al. (2011) observe that the external factors are the significant drivers of the domestic credit growth, especially in developing Asian economies. However, Elekdag and Han (2015) find that the domestic factors (mainly domestic monetary policy implications) are the main determinants of the domestic credit growth in 10 developing Asian economies.

Guo and Stepanyan (2011) also analyze the determinants of the domestic credit growth in 38 emerging market economies for the