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Cross-border spillovers of monetary policy: What changes during a financial crisis?

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ABSTRACT

This paper analyses cross-border spillovers of monetary policy by examining two countries that were in the eye of the storm during the euro area sovereign debt crisis, namely Ireland and Portugal. The research provides insight as to how banking and sovereign stress affect the inward transmission of foreign monetary policy to two economies that share many characteristics, but that also have many distinct features. In particular, our research addresses the question of whether a banking system in distress reacts more or less to monetary policy changes in other major economies. The empirical analysis indicates that international spillovers are present for US and UK monetary policy for both Ireland and Portugal, but there is heterogeneity in the transmission mechanisms by which they affect credit growth in the two economies.

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1. Introduction

Global factors, including the monetary policy stance of major economies, have been important determinants of financial conditions in advanced economies over the past 15 years. The period preceding the global financial crisis witnessed a surge in the international activities of global banks, reflected in an expansion of their balance sheets funded by the international wholesale markets, and manifested in the significant growth of cross-border banking flows during the mid-2000s (BIS, 2011). Consequently, cross-border banking flows were the key channel through which permissive financing conditions in global financial markets were disseminated internationally (Bruno and Shin, 2015).

Financial liberalisation, free movement of capital in the European Union, and the advent of the euro were also contributory factors determining the increases in cross-border banking inflows to Europe (Hale and Obstfeld, 2014). Indeed, increasing financial globalisation has also motivated the focus of a number of studies on the international aspect of monetary policy transmission to domestic and cross-border credit supply (such as Cetorelli and Goldberg, 2012; Correa et al., 2015; Bruno and Shin, 2015).

This paper compares and contrasts the international spillovers of monetary policy from the US and UK to Ireland and Portugal.[1] Ireland and Portugal warrant joint scrutiny for the study of international spillovers of monetary policy for a number of

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[1] The paper is part of a collective research project under the aegis of the International Banking Research Network (IBRN). As described in Buch et al. (2018), in this project researchers from 17 central banks use confidential bank-level data to explore the international transmission of monetary policy using a common methodological framework. For further details on the IBRN, visit https://www.newyorkfed.org/ibrn.

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reasons. From a complementary perspective both countries (i) are small open economies, (ii) have a common currency, the euro, (iii) experienced considerable international leverage during the pre-crisis period, (iv) were at the crux of the euro area sovereign debt crisis, (v) relied heavily on Eurosystem official liquidity during the sovereign debt crisis, and (vi) needed to draw on international financial assistance from the IMF and European authorities.

However, despite these commonalities, the building blocks of the crises are quite different. In Ireland the crisis had its roots in a real estate bubble and in imbalances in the financial system (Honohan, 2009). In contrast, for Portugal the crisis was more associated with structural weaknesses in the economy, which became unsustainable when access to international debt markets disappeared (Alves et al., 2016). These differences make this joint study even more valuable, as we can explore how different paths leading up to a crisis, in which the two economies were in the eye of the storm, can influence the international transmission of monetary policy. There are also important differences in the way the two countries have been recovering from the crisis, as well as on structural characteristics of the economies, most notably in terms of competitiveness and degree of openness to trade (with potentially important impacts on the cross-border spillovers of monetary policy).

To study the transmission of monetary policy, it is crucial to consider the heterogeneity within the banking system (Kashyap and Stein, 2000; Gambacorta and Marques-Ibanez, 2011). This is even more important when covering a period of financial instability (Ciccarelli et al., 2013). We explore several bank-level characteristics related to funding and portfolio frictions that may influence the cross-border transmission of monetary policy.[2]

Funding frictions relate to the traditional literature on the bank lending channel, in which tightening a monetary policy decreases the supply of credit (Bernanke and Blinder, 1988; Bernanke and Gertler, 1995; Kashyap and Stein, 1995). This channel might work across borders. Following a monetary policy tightening abroad, the value of banks' foreign currency liabilities increases and may be associated with a tightening of domestic financial conditions (Kearns and Patel, 2016). To capture this, we consider the extent to which banks are exposed through cross-border liabilities to the countries where monetary policy is changing. We also examine the role that banks' liquidity might have in lessening the international pass-through of monetary policy.

Portfolio frictions relate to the fact that banks' choices in terms of asset composition and capital structure may also play an important role in shaping the transmission of monetary policy. On the one hand, banks with more assets whose value changes after a monetary policy decision abroad might be more likely to transmit the shock to credit granted at home, since they suffer a larger shock. On the other hand, banks with larger foreign exposures might be more prone to rebalance their portfolio between domestic and foreign assets when monetary policy changes abroad. For instance, a tightening of UK monetary policy reduces the creditworthiness of UK borrowers and their collateral values. Due to this increase in the perceived riskiness of foreign assets, banks might move away from foreign assets to domestic (perceived safer) assets. Both mechanisms are akin to the balance sheet channel of monetary policy, in which a tightening of monetary policy is associated with a deterioration in the net worth of borrowers and their collateral values (Bernanke and Gertler, 1995).

We employ bank-level data from Ireland and Portugal to explore whether there are international spillovers of monetary policy to two small open economies that share a common currency. In addition, we analyse the key commonalities and differences of transmission before and during the euro area sovereign debt crisis. The empirical analysis shows that international spillovers are present for US and UK monetary policy, but the mechanisms through which they affect credit in Ireland and Portugal depend on the time period analysed.

Overall, the results indicate that international funding frictions are present for both economies prior to the euro area sovereign debt crisis. Furthermore, liquid assets play a mitigating role in offsetting a funding shock driven by changes in foreign monetary policy. During the sovereign debt crisis period, international funding frictions lose all relevance. These findings are in line with expectations given the international leverage of both banking systems during this period.[3] After the crisis started banks in both countries became heavily dependent on domestic central bank official liquidity due predominantly to the retrenchment of international funding, thereby explaining the lack of evidence on cross-border transmission of monetary policy.[4]

The empirical analysis also shows that some portfolio decisions of banks work as frictions for the cross-border transmission of monetary policy, working as either amplification or mitigation mechanisms. The results are diametrically different for the two countries depending on the monetary policy measure used and the period under review. The empirical analysis indicates that prior to the crisis, the asset structure of Irish banks is irrelevant for the cross-border transmission of monetary policy. This possibly reflects the motivation of Irish banks to expand lending abroad in the pre-crisis period, which was driven by the desire to diversify their portfolios.[5]

After the crisis started these cross-border portfolio channels become operational for Ireland but lose relevance for Portugal. This possibly reflects the longer and deeper crisis experience in the Portuguese economy, as well as the prevalence of legacy assets in the banking system for a longer period (Blanchard and Portugal, 2017).

The remainder of the paper is structured as follows. Section 2 presents the stylised facts on the evolution of imbalances and across the two economies since the start of the euro, and their subsequent unwinding during the euro area sovereign

[2] The mechanisms of transmission used in this internationally coordinated research project are described in greater detail in Buch et al. (2018).

[3] See Honohan, 2009; Coates and Everett, 2013; Everett, 2015, and Lane, 2016 for details of the Irish banking system's international leverage. See Lane, 2012; Lane and Milesi-Ferretti, 2012; Reis, 2013, and Alves et al., 2016 for details of the Portuguese banking system and current account imbalances.

[4] Coates and Everett, 2013; Everett et al., 2015, and Alves et al., 2016.

[5] Kearns (2007).

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