Journal of International Money and Finance 32 (2013) 884–915

Contents lists available at SciVerse ScienceDirect

Journal of International Money and Finance

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

Financial crises and cross-border banking: New evidence

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JEL classification:
F3
G01
G15
G21

Keywords:
Cross-border banking
Systemic banking crisis
Currency crisis
Gravity model
Currency union
Banking geography

A B S T R A C T

The surge in cross-border banking prior to global financial crises took place not only in the interbank market but also in the retail market, e.g. between banks and their private customers abroad. We utilize confidential data to estimate for the first time the effects of banking, currency and twin crises on the geography of cross-border deposits and loans. We show that each crisis type has its own specific effects, that these effects themselves lead to sustained increases in cross-border banking, and that they are different for cross-border loans and deposits, respectively.

1. Introduction

Cross-border banking has been increasing rapidly in the past decade not only in the interbank market but also in the retail market, especially between banks and their non-bank customers abroad. According to the Bank of International Settlements (BIS, 2011: 46), "direct cross-border ("offshore") lending to non-banks and the cross-border component channeled by resident banks – become more important. That is, during booms these two international components tend to grow faster than the credit granted by banks located in the country." In a similar vein, Shin (2011) argues that cross-border banking has played an important role in the build-up of the 2007/08 financial crisis, with European banks acting as an important financial intermediary for the US, rivaling even the intermediation size of the domestic financial sector. In the Eurozone, cross-border banking has also been a driving factor behind the credit booms and housing bubbles in countries such as Spain and Ireland (BIS, 2011). The recent literature is increasingly recognizing that it is important to analyze cross-border banking at a gross and not a net (flow) level for understanding the 2007/08 crisis (Borio and Disyatat, 2011; Shin, 2011) because both

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0261-5606/$ – see front matter
http://dx.doi.org/10.1016/j.jimonfin.2012.07.007

cross-border lending and depositing have increased dramatically in the past 15 years, each driven by different factors and with different impacts on the financial sector and the global economy.

The term "cross-border banking" is used for both banks as well as banking customers "going abroad". While most studies on cross-border banking focus either on banks that "go abroad" or on interbank relations, we focus here on the largely neglected customer side and their willingness to deposit or borrow abroad before, during and after financial crises episodes.

To address this customer view of financial crises, this paper utilizes bilateral country-level data on cross-border banking outside the interbank market, which have been made available on a confidential basis by the BIS. The large size of the database allows us to estimate the impact of almost 200 financial crises – differentiated as systemic banking, currency or twin crisis – on the geography of cross-border banking. The unique bilateral nature of our data enables us to investigate how non-bank customers respond to a crisis in their respective home countries.

Our study contributes to the understanding of the crisis effects on international banking in three ways: First, we complement the traditional bank point of view with the new customer point of view. While crisis-affected banks have been found to reduce domestic as well as cross-border lending, we show that crises also have the effect of increasing cross-border banking, when driven from the side of the customers, living in countries affected by crises and searching for reliable lenders – or in case of deposits – for safe havens abroad. By focusing on crises in customer countries, we can indirectly shed light on the international activities of banks in countries that themselves are not experiencing a crisis. Therefore, we can demonstrate that while crises reduce financial globalization for the affected banks they can simultaneously increase globalization for unaffected banks who respond to customer demand, thus changing the geography of global retail banking.

Second, we are the first to document the effects of crises not only on cross-border lending but also on cross-border depositing. Deposits provide the cleanest evidence for the customer point of view as they are largely customer-driven and banks have little incentive to reject deposits. In contrast, cross-border loans are strongly affected by both, demand and supply, e.g. during crises customers might increasingly demand cross-border loans but foreign banks can be reluctant to lend due to substantial information asymmetries. Our results indicate that cross-border deposits and loans do indeed require a differentiated analysis and that they respond differently to financial crises. Customers try to raise loans abroad early on as domestic banks ration credit already before the onset of a crisis. In contrast, customers move deposits abroad only after the crisis is well underway – possibly as they initially still believe in the protection provided by the domestic deposit insurance scheme.

Third, we show that it is important to differentiate carefully between the effects of systemic banking, currency and twin crises on cross-border banking. Using the Laeven and Valencia (2008, 2010) financial crisis database we show that due to their severity, twin crises typically lead to more cross-border banking in both loan and deposit markets than a systemic banking or currency crisis alone. However, the effects of twin crises also dissipate more quickly over time possibly due to strong policy responses and bank restructurings.

Finally, using the recent history of systemic banking crises and contrasting it with the current 2007/08 crisis we deliver some important insights. Whereas Reinhart and Rogoff (2009) have contested the pre-crisis view widely held by the financial markets that "This Time Is Different", we provide the first evidence – at least in terms of the post-crisis impact on the geography of global retail banking – that this time has indeed been different.

The plan of the paper is as follows: Section 2 puts our study in the context of cross-border banking and develops hypotheses. Section 3 introduces the methodology, Section 4 describes our datasets and Section 5 presents the results of our empirical analyses including extensive robustness checks. Section 6 concludes.

2. Cross-border banking and financial crises

Financial crises with an impact on cross-border lending and depositing can occur in the bank country, in the customer country or in both at the same time. The literature has covered the impact of these different occurrences of financial crises with different emphasis, while we intend to treat them here with equal weight.