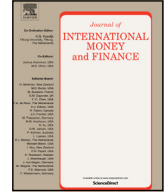




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Do capital flows change domestic credit allocation?



Anna Samarina^{*}, Dirk Bezemer

University of Groningen, The Netherlands

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ABSTRACT

Since the 1990s, domestic bank credit has been reallocated away from lending to non-financial business and toward households. An expanding literature discusses negative effects on growth and stability of this change in credit allocation. We research its drivers. We hypothesize that if foreign capital flows into economies with few investment opportunities, it may substitute for domestic bank lending to non-financial business, so that bank balance sheets become more dominated by household lending. In GMM estimations on data for 36 economies over 1990–2011, we find evidence consistent with this mechanism. Foreign capital inflows into the non-bank sector (but not into the bank sector) are associated with lower shares of business lending in domestic bank portfolios. The association is weaker in economies with more investment opportunities, whether proxied by investment shares, current account surpluses, or EMU membership. Our results highlight the importance of sectoral destination in determining the effects of capital flows.

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1. Introduction

The level and allocation of bank loans has changed profoundly in recent decades. In a sample of 17 advanced economies, Jorda et al. (2014) observe an average increase of credit-to-GDP of 78 percentage points between 1960 and 2010. While traditionally most bank credit goes to non-financial business, more than two thirds of the increase observed by Jorda et al. (2014) was an expansion of

^{*} Corresponding author. Tel.: +31 50 363 3689.

E-mail address: h.samaryna@rug.nl (A. Samarina).

household credit. In the present paper, we find that over 1990–2011 in a sample of 36 countries, the non-financial business credit share in all bank loans declined from 54% to 42% on average.

The rapid change in allocation of domestic bank credit raises concerns about its growth and stability effects, as a small but expanding literature shows. Less lending to business, and more household credit, causes lower private savings (Jappelli and Pagano, 1994) and slower economic growth (Beck et al., 2012; Bezemer et al., 2014). Economies with more household credit have larger external imbalances (Büyükkarabacak and Krause, 2009), increased probability of crisis, and both deeper and longer post-crisis recessions (Barba and Pivetti, 2009; Claessens et al., 2010; Büyükkarabacak and Valev, 2010; Cecchetti et al., 2011; Lane and Milesi-Ferretti, 2011; Berkmen et al., 2012; IMF, 2012; Sutherland et al., 2012; Babecky et al., 2013; Jappelli et al., 2013; Beck et al., 2014). These effects run through both consumption channels (Dynan, 2012; Mian and Sufi, 2009, 2014) and investment channels (Chakraborty et al., 2014). This evidence points to the danger that the relative decline of loans to non-financial business increases financial fragility.

In this paper we research the conditions in which this change occurred, focusing on capital flows. Since net capital flows reveal little about financing conditions (Borio and Disyatat, 2011; Borio et al., 2014), we use gross capital inflows. We separate capital inflows according to their sectoral destination as inflows into banks and into non-banks. We test the hypothesis that capital inflows into non-banks are associated with a decrease in the share of domestic bank loans to non-financial businesses (the ‘non-financial business loan share’): businesses substitute domestic bank loans for foreign finance.

In order to observe the allocation of bank loans, we collected data from the consolidated balance sheets of monetary financial institutions in 36 countries over 1990–2011 (with the time period dictated by data availability). We also gathered data on debt and equity capital inflows separately into the bank and non-bank sectors, and control variables.

Exploration of the data shows that the decline in banks’ non-financial business loan share coincided with a surge in capital inflows, especially from around 2002–2003. In panel GMM models, we find that the decline in the non-financial business loan share is significantly associated with growth in credit-to-GDP ratios, credit market deregulation, stock market capitalization, and capital inflows into the non-bank sector. The association of a falling non-financial business loan share with foreign capital into the non-bank sector is stronger in economies with scarce investment opportunities, where domestic and foreign finance compete for funding investments. Investment opportunities are likely to be larger in countries with high investment-to-GDP ratios, in current account surplus economies, and in EMU member states, with its large internal market and common currency (15 of 36 countries in our sample are EMU members). Using each of these variables as proxies for investment opportunities, we find positive and significant marginal effects. This indicates weaker associations of falling non-financial business loan share with foreign capital flows into the non-bank sector in economies with more investment opportunities.

Our findings are in line with the hypothesis that the link from larger capital inflows to more fragile bank loan portfolios (dominated by household rather than non-financial business credit) runs via foreign capital into the non-bank sector, and that this link is stronger when investment opportunities are fewer. There are potential implications for macroprudential policy and for the regulation of capital flows, which we discuss in more detail in the concluding section. Our methods and data constitute limitations on the firmness of our conclusions, and we suggest that this hypothesis merits further research.

The paper proceeds as follows. In Section 2 we discuss the conditions which may link capital inflows to domestic credit allocation. In Section 3 we introduce and explore the data. Section 4 describes the methodology. In Section 5 we present and discuss the estimation results. Section 6 concludes with a summary and reflection on the limitations of this study, and avenues for future work.

2. Capital flows and domestic credit allocation

Capital flows may be part of the catching-up process of less productive economies through formation and upgrading of productive capacity. They may support growth and external sustainability, provided capital flows finance productive investment in tradable goods, such that repayment is assured by a future export surplus (Blanchard and Giavazzi, 2002; Eichengreen, 2010; Lucas, 1990). In this scenario, capital flows should lead to rising investment by non-financial firms in the tradable sector.

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