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## What is the major determinant of cross-border banking flows?



Toyoichiro Shirota<sup>\*,1</sup>

Bank of Japan, 2-1-1 Hongokucho-Nihonbashi, Chuo-ku, Tokyo, Japan

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### ABSTRACT

This study examines the major determinant of cross-border credit flows through global banks across 70 countries. Employing a Bayesian dynamic latent factor model, we decompose volatilities of banking flows into the contribution of a global common factor, regional common factor, and country-specific factor. The results indicate that the global and regional common factor explains about 40–50 percent of volatility in overall cross-border banking flows. In particular, the contribution of the global common factor increased in the 2000s. Simultaneously, main determinants are largely heterogeneous across countries: this implies that the desirable policy response to credit inflows may differ for each host country.

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### 1. Introduction

Following the financial crisis in the late 2000s, international capital flows have received substantial attention. The surges and retrenchments of capital flows before and after the financial crisis are sometimes referred to as “Liquidity Tsunami,” suggesting that the low interest rate environment in the advanced economies induces liquidity overflows around the world.

\* Tel.: +81 3 3277 1111.

E-mail address: [toyoichirou.shirota@boj.or.jp](mailto:toyoichirou.shirota@boj.or.jp).

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Active capital inflows are a dual-edged sword for the recipient countries. On the positive side, capital flows support economic growth and provide welfare gains by financing productive investment opportunities and consumption smoothing. On the negative side, capital surges tend to bring inflationary pressures and capital account deficits, making the economy more vulnerable to external shocks. Further, once capital retrenchment begins, the economy would experience acute deterioration of the economic activities and welfare losses due to consumption volatility.

Among several forms of capital flows, credit flows through globally active banks (hereafter global banks) are becoming a topic of debate. This is partly because global banks have enormously expanded their international transactions since the 2000s.<sup>2</sup> In addition, ongoing reforms of financial regulations also facilitate discussions on global banking activities, which are considered a source of the recent financial turmoil that rapidly spread across the globe.

This study provides a quantitative assessment on the major determinants of cross-border credit flows from global banks across 70 countries in seven regions of the world, using International Banking Statistics of the Bank for International Settlements (BIS). More specifically, we decompose the volatilities of banking flows into the contributions from a global common factor, regional common factor, and country-specific factor.

The global common factor and regional common factor represent global and regional co-movements in credit flows. These common movements tend to be affected by financial conditions in headquarters or global funding markets especially in normal times.<sup>3</sup> In contrast, the country-specific factor represents domestic conditions within recipient countries such as government debt, country risks, and macroeconomic fundamentals. Following the literature, the global common factor and regional common factor correspond to “push factors” and the country-specific factor and other idiosyncratic factors correspond to “pull factors.”<sup>4</sup>

Quantitative assessment of the determinants of cross-border banking flows is important for considering the sustainability of credit inflows to recipient countries and drawing policy implications. If push factors are the dominant sources of fluctuations, global banking flows are driven by centralized decisions of home countries. Then, cross-border banking flows would reverse easily in the case of turmoil in home countries and could be potential sources of local market volatilities for recipient countries. Hence, it is rationalized that regulators in recipient countries adopt a liquidity “ring-fence” regulation that restricts global banks from reallocating their funds globally (e.g., [Committee on the Global Financial System \(2010\)](#)). Adversely, if local pull factors are the primary sources of fluctuations, then global banking flows are driven more by the total-optimization decisions based on the risk-adjusted relative profitability for each host location. Accordingly, they would be more stabilizing and minor in the transmission of global shocks to recipient countries.

The results of this study indicate that the global and regional common factor explains about 40–50 percent of volatility in overall cross-border banking flows: it suggests that the international propagations of shocks through global banks are quantitatively important. At the same time, large heterogeneity exists in the main determinant of credit inflows: some countries are mainly affected by the global and regional common factors whereas others are mainly affected by local pull factors such as country-specific and idiosyncratic factors. The observed heterogeneity implies that the desirable policy response to credit inflows may differ for each host country.

[Calvo et al. \(1996\)](#) initiated the literature that examines the determinants of international capital flows in terms of the “push factors” of advanced countries and “pull factors” of developing countries.<sup>5</sup> After the financial crisis in the late 2000s, the determinants of global capital flows gained renewed attention. [Forbes and Warnock \(2012\)](#), [Bruno and Shin \(2015\)](#), and [Rey \(2013\)](#) all indicate that global

<sup>2</sup> According to the consolidated banking statistics from BIS, the balance of the external assets of global banks at end-June 2012 has expanded 2.9 times from 2000. Furthermore, the country-level aggregate statistics of [Lane and Milesi-Ferretti \(2008\)](#) indicate that the stock of cross-border banking is more than 50 percent of the overall amount of international holdings.

<sup>3</sup> In a time of financial turmoil, the commonalities in credit flows stem from interactions among real and financial factors.

<sup>4</sup> It is not evident that the regional common factor should be categorized as a “push factor” or “pull factor.” For descriptive purposes, this study categorizes the regional common factor as a “push factor” with regionally contagious flows in mind.

<sup>5</sup> Vast amounts of research have been accumulated in the literature such as [Calvo et al. \(1996\)](#), [Fernandez-Arias \(1996\)](#), [Kim \(2000\)](#), [Taylor and Sarno \(1997\)](#), [Chuhan et al. \(1998\)](#), and [Hernandez et al. \(2001\)](#).

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