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**Working Paper**

## International bank lending: Water flowing uphill?

WIDER Discussion Paper, No. 2002/42

**Provided in Cooperation with:**

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*Suggested Citation:* Hawkins, John (2002) : International bank lending: Water flowing uphill?, WIDER Discussion Paper, No. 2002/42, ISBN 9291902071, The United Nations University World Institute for Development Economics Research (UNU-WIDER), Helsinki

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United Nations  
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**WIDER**

World Institute for Development Economics Research

Discussion Paper No. 2002/42

## **International Bank Lending**

Water Flowing Uphill?

John Hawkins\*

April 2002

### **Abstract**

International bank lending is a major component of capital flows between advanced and emerging economies. However, in recent years these flows have been going the wrong way, like water flowing uphill. Even four years after the Asian crisis, there is a net flow of funds from emerging economies to banks in advanced economies. This paper looks at this phenomenon, starting by setting out the relevant data, and then looking at factors influencing these flows. These include both cyclical influences (both 'push' and 'pull') and structural changes within the banking industry. There is some evidence that international lenders are now discriminating more between the various emerging economies.

Keywords: international bank lending, capital flow

JEL classification: F3, N1, F4

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This study has been prepared within the UNU/WIDER project on Capital Flows to Emerging Markets since the Asian Crisis, which is co-directed by Professor Stephany Griffith-Jones and Dr Ricardo Ffrench-Davis.

## Author's note

Any opinions expressed are those of the author and not necessarily shared by the BIS. Helpful comments were received from Palle Andersen, Charles Freeland, Stephany Griffith-Jones, Marc Klau, Elmar Koch, Philip Turner, Agustin Villar, Karsten von Kleist, Christina Luna, Marian Micu, Beatrice Weder, Rainer Widera and participants at seminars in Santiago and Helsinki. Bruno Allemann, Melissa Fiorelli, Marc Klau and Denis Pêtre assisted with the data.

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Camera-ready typescript prepared by Jaana Kallioinen at UNU/WIDER  
Printed at UNU/WIDER, Helsinki

The views expressed in this publication are those of the author(s). Publication does not imply endorsement by the Institute or the United Nations University, nor by the programme/project sponsors, of any of the views expressed.

ISSN 1609-5774  
ISBN 92-9190-206-3 (printed publication)  
ISBN 92-9190-207-1 (internet publication)

## 1 Bank lending and other capital flows

International bank lending is a very important component of capital flows to emerging economies. Moreover, bank lending has been the most variable type of capital flow. Table 1 shows how foreign direct investment, and even portfolio investment, held fairly steady through the Asian crisis. However, the international banks went from lending large amounts before the crisis to withdrawing large amounts after it.

## 2 BIS data on international bank lending – description<sup>1</sup>

The BIS compiles and publishes the most comprehensive data on international bank lending, which is used in putting together the IIF estimates cited above and the statistics on external debt published jointly with the World Bank, IMF and OECD. The great advantage of these data is that they are compiled from the creditor side in a consistent way. The disadvantage is that they cover only part of capital flows, albeit perhaps the volatile part. IMF data on capital flows are based on balance of payments reports of recipient countries and are more comprehensive. However, it is known that the reporting of capital flows is inevitably rather inaccurate (although major progress has been made in recent years as a result of the efforts of the IMF Committee on Balance of Payments Statistics).

The BIS data, described in more detail in Annex A, are compiled on two bases. The *locational* statistics report on activities of banks within the reporting economy, regardless of their ownership, but not including their foreign subsidiaries. The *consolidated* statistics report on global activities (including foreign subsidiaries) of banks whose head office is located in the reporting economy.

Table 1  
Emerging market economies' net external financing  
US\$ billion

	1996	1997	1998	1999	2000	2001f
Direct equity investment	93	116	121	148	130	124
Portfolio equity investment	35	25	14	16	16	4
Bank lending	118	44	-55	-48	-6	-23
Non-bank private lenders	89	84	64	26	26	0
Official flows	5	47	52	11	-1	30
Total external financing	340	316	195	152	166	136

Source: Institute of International Finance (2001a,b).

<sup>1</sup> For further details, see BIS (2000), BIS (2001) and Fiorelli (2000).

When appropriately scaled, the BIS data may be helpful in identifying economies where the accumulation of borrowing from international banks is leaving them vulnerable to a loss of confidence; see Hawkins and Klau (2000). Often excessive capital inflows have funded domestic speculative booms. The central bank governors of the G10 countries have been regularly briefed over the years on signs of impending trouble. A recently published account by an eminent insider, Alexandre Lamfalussy (2000), who was Economic Adviser at the BIS from 1976 and then General Manager, points out that the governors agreed in the 1970s to publish country-by-country data on external bank-debt accumulation only after some hesitation because naming countries could in itself precipitate crises. Yet even though these data were publicly available before the Asian crisis, at the time they attracted relatively little attention despite efforts by the BIS to draw attention to the warnings they were giving. Hawkins (1999) points out that in early 1997 the BIS data showed the large, rapidly-growing and increasingly short-term debt incurred by the five Asian emerging economies which soon after suffered massive depreciations.

### **3 The pattern of international bank lending**

#### **3.1 Specialisation by lending countries**

The BIS consolidated statistics are published by nationality of reporting bank, so that for example, it is possible to see the exposure of German-owned banks to Russia, or Spanish-owned banks to Brazil. The distribution of lending to emerging economies is summarised in Table 2. It shows that European-owned banks are the largest lenders to all regions,<sup>2</sup> but there is also a degree of specialisation. Japanese-owned banks mainly lend to the Asia-Pacific region while US-owned banks concentrate on Latin America. Within Europe, German-owned banks are the main lenders to central and eastern Europe while French-owned banks are the main lenders to Africa and Spanish banks are large lenders to Latin America.

Two recent trends are of particular significance. The first is the withdrawal of Japanese banks from Asia (both from the developing countries and from Hong Kong); from its peak in June 1995, by mid-2001 this had fallen by around two-thirds, a decline of almost US\$200 billion, although some of this is just booking Japanese lending business within Japan rather than offshore. The second is the rapid growth of Spanish banks' exposure in Latin America. In the five years to mid-2001, this has almost quadrupled, an increase of almost US\$40 billion.

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<sup>2</sup> It has been suggested that a more ready granting of guarantees and support by export agencies is a factor encouraging international lending by European banks.

Table 2  
Consolidated international claims of BIS reporting banks on developing countries  
US\$ billion, end 2000

	Total	Of which to:			
		Asia-Pacific	Europe	Latin America	Mid-East & Africa
Total; of which by:	876	280	189	285	121
Europe; of which:	545	131	145	183	85
Germany	163	39	67	36	21
France	82	27	12	20	23
United Kingdom	73	25	7	25	15
Spain	56	1	2	52	2
United States	97	21	10	57	10
Japan	77	56	5	10	6
Other	157	72	29	35	21

Source: BIS.

### 3.2 Maturity of bank lending

Around half of international bank lending to emerging economies is short-term, i.e. with remaining maturity of less than a year (see Table A1 in Annex A). The proportion rose through the first half of the 1990s; Jeanneau and Micu (2002) attribute this to ‘the growth of trade financing, the liberalisation of financial sectors, the establishment of offshore financial centres and the advantages offered by short-term loans in the monitoring and management of international exposures.’ Short-term borrowing is usually cheaper but exposes the borrower to refinancing risks. As borrowers found short-term credit was sometimes cut off during the Asian and other crises, they have increasingly felt the higher interest rates were worth paying and so maturities have lengthened again. Some borrowing countries have adopted specific guidelines to lengthen debt maturities.

### 3.3 Concentration of bank lending

It is often claimed that international bank finance to emerging economies is unduly concentrated. At first sight, this appears to be the case, as over 60 per cent of international bank loans to emerging economies go to just ten countries. In order, these are Argentina, Brazil, Mexico, Korea, China, Turkey, Indonesia, Russia, Thailand and Chile. However, it is *less* concentrated than are population, GDP or other forms of capital inflow (Table 3). The list of the top ten recipients of bank lending is very similar to the ten largest emerging economies, with the exception that India receives much less lending than the size of its economy would suggest. The OECD members receive more (perhaps partly a consequence of their favoured treatment under the Basel capital accord – see below).

At the other end of the distribution, the 25 poorest economies (mostly African, with per capita incomes below US\$1000) receive only about 1 per cent of international bank lending. While these economies account for 10 per cent of the population of emerging economies, they only account for 2 per cent of GDP. Moreover, lending to many of the

poorest countries is almost entirely short-term, creating additional vulnerabilities. These characteristics suggest that international bank lending may not be the ideal vehicle for providing finance to the smallest and poorest countries.

### 3.4 Currency denomination of borrowing by emerging economies

Most emerging economies, particularly those with a history of high inflation and depreciation, face a significant lacuna in financial markets. As a result of what Eichengreen and Hausmann (1999) call ‘original sin’, they face great difficulty in marketing long-term securities denominated in the domestic currency. In addition, foreign lenders will not lend in the domestic currency (Table 4) and will tend to be unwilling to stand on the other side of a hedge contract.<sup>3</sup> In these circumstances firms can only choose between a currency mismatch and a maturity mismatch.

## 4 Recent trends in net bank finance to emerging economies

### 4.1 Bank lending

The cutbacks in international bank loans outstanding to emerging economies evident since the Asian crisis moderated during 2000 and 2001 (Table 5 and Graph 1). There were continuing, albeit much more modest, declines in loans to emerging Asia.<sup>4</sup> There was some increase in loans to Latin America, but this was partly a reflection of the purchase by Spanish banks of privatised Brazilian banks. For most of 2000, Turkey received significant amounts of new lending but this was sharply reduced in early 2001.

Table 3  
Concentration ratios  
Percentage shares of emerging economies<sup>1</sup>

		Share of top 5	Share of top 10
International bank lending <sup>2</sup>	(end 2000)	40	62
International bond issuance	(end 2000)	65	83
Stock of inward foreign direct investment	(2000)	53	68
Population	(1999)	55	66
GDP (PPP basis)	(1999)	53	67

<sup>1</sup>data cover 126 emerging economies with population over 1 million and per capita GDP of below around US\$15,000 (i.e. about the level of South Korea).

<sup>2</sup>consolidated basis (for explanation, see annex A).

Sources: World Bank Atlas 2001, UNCTAD World Investment Report 2001 (annex table B.3), BIS Quarterly Review June 2001 (tables 9A and 11).

<sup>3</sup> Hedging between domestic agents is like playing ‘pass the parcel’ and does not reduce the national exposure.

<sup>4</sup> For a more detailed analysis of flows to Asia, including analysis based on individual bank data, see Cailloux and Griffith-Jones (2000).

Table 4  
Borrowing by domestic non-banks from international banks:  
percentage denominated in domestic currency<sup>1</sup> (end-2000)

Asian emerging economies		Latin American emerging economies		Other emerging economies		Advanced economies	
China	7	Argentina	1	Czech Rep	11	Australia	26
India	2	Brazil	1	Hungary	0	Germany	21
Indonesia	8	Chile	0	Israel	1	Hong Kong	17
Korea	7	Colombia	0	Poland	4	Japan	29
Malaysia	6	Mexico	0	Russia	1	Singapore	15
Philippines	7	Peru	0	South Africa	15	United Kingdom	26
Thailand	5	Venezuela	0	Turkey	1	United States	83

<sup>1</sup>For some emerging economies the figures may be overestimates as it is assumed all loans and bonds not denominated in a major currency are denominated in the domestic currency.

Source: BIS.

Table 5  
International financing of developing economies  
Billions of US dollars, at annual rate

	International bank lending <sup>1</sup>			International debt securities <sup>2</sup>		
	1990–1997	1998–1999	2000	1990–1997	1998–1999	2000
All developing economies <sup>3</sup>	48	-74	-13	54	37	40
Asia-Pacific <sup>3</sup>	39	-79	-29	21	-1	2
Of which: China	8	-14	-5	2	-1	-0
Crisis-hit Asia <sup>4</sup>	27	-59	-17	17	0	3
Latin America & Caribbean	8	-12	14	26	24	28
Africa						

<sup>1</sup>Exchange rate adjusted change in claims of BIS reporting banks <sup>2</sup>net issuance <sup>3</sup>excludes Hong Kong and Singapore <sup>4</sup>Indonesia, Korea, Malaysia, the Philippines and Thailand.

It is striking that even four years after the Asian crisis, bank lending to emerging economies has not recovered. Several reasons have been suggested.<sup>5</sup> There has been an unusual period in recent years when Latin America and much of Asia grew slower than the global average (Table 6). Many emerging market borrowers in Asia are running current account surpluses, as following the 1997–98 crises, imports have been held down by weak domestic consumption and investment while exports have benefited from improved competitiveness following the large devaluations. More recently, the slowdown in the US economy has induced further wariness on the part of lenders. The Asian economies are particularly suffering from the weakness in US technology

<sup>5</sup> See Wooldridge (2001) and Cohen and Remolona (2001).



industries. Furthermore, as discussed further below, banks in the industrial countries have increasingly sought credit exposure in emerging economies by purchasing local banks, rather than through cross-border lending. Recent problems in Argentina and Turkey are likely to be dampening enthusiasm for lending to emerging economies, although the extremes of contagion seen in earlier crises have not been observed.

## 4.2 Deposits from emerging economies

Furthermore, deposits from emerging economies have been growing strongly. In 2000, deposits were equivalent to 2 per cent of emerging economies' GDP – the largest proportion since 1979–80 when oil-exporting countries placed windfall revenues with international banks. The main sources of these deposits were Taiwan, mainland China and the oil-exporting countries (notably Saudi Arabia, Iran, Mexico and Russia). In the case of China, weak demand for foreign currency loans and interest rate differentials were important reasons. More generally, a sharp rise in residents' deposits in overseas banks is often regarded as symptomatic of 'capital flight'. A more gradual rise in these deposits may just reflect portfolio reallocations. Many countries had discouraged or prohibited funds managers (unit trusts, pension and mutual funds etc) from investing abroad so as to retain scarce capital for domestic development. These rules have been gradually eased in a number of countries. For example, in Chile, the allowable proportion of assets invested abroad was raised from 2 per cent in 1992 to 16 per cent in 2000 as the authorities wished to reduce their concentration of risk. In many cases these funds managers are using this greater freedom to place funds with international banks.<sup>6</sup>

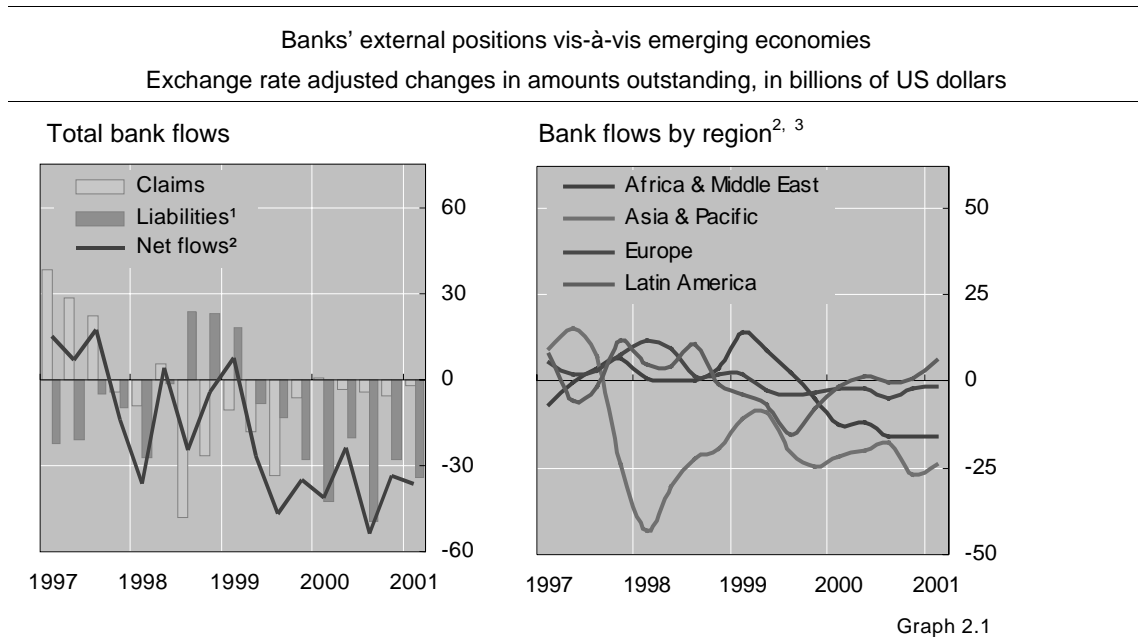
Table 6  
Real GDP, actual and forecast  
Average annual percentage change

	1950–1996	1996–2001 <sup>5</sup>	2001–2010f
Western Europe <sup>1</sup>	3.5	2.7	2.6
United States	3.2	3.9	3.2
Emerging Asia <sup>2</sup>	6.3	5.6	6.8
<i>Of which: crisis-hit</i>	5.9	1.8	5.0
Latin America <sup>3</sup>	4.3	3.1	4.6
World <sup>4</sup>	4.1	3.6	4.3

<sup>1</sup>weighted average of 15 western European economies <sup>2</sup>weighted average of China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand, of which underlined are classified as crisis-hit. <sup>3</sup>weighted average of Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. <sup>4</sup>weighted average of 43 economies with over 85 per cent of global GDP. <sup>5</sup>includes consensus forecasts for 2001. f: Consensus forecasts.

<sup>6</sup> According to US balance of payments data, net inflows to the United States from emerging economies averaged around US\$70 billion during 1999 and 2000 compared to a net average outflow of around US\$40 billion during the three preceding years. While much of this went into buying government bonds or in portfolio investment, some would have been deposited in banks. Private pension funds in Latin America are now estimated to have around US\$170 billion in funds under management.

Graph 1



<sup>1</sup>A negative (positive) value indicates an increase (decrease) in BIS reporting banks' liabilities vis-à-vis emerging economies.

<sup>2</sup>Changes in claims minus changes in liabilities.

<sup>3</sup>Two-quarter moving average.

Source: BIS locational banking statistics.

## 4.2 Net bank funding

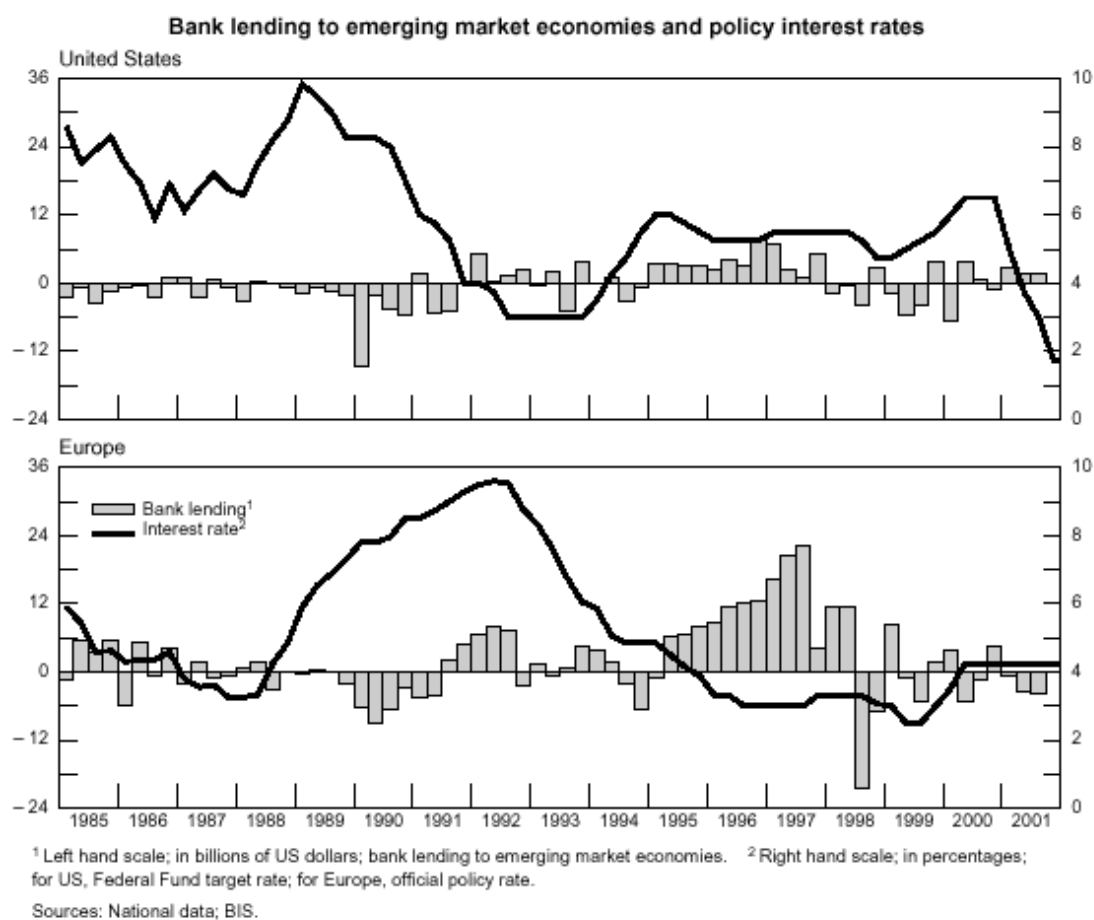
With lending at best flat and deposits rising, funds flowed from emerging economies to the banks (Graph 1). The IIF estimates included in Table 1 envisage banks withdrawing more money from the emerging economies in 2001. International bank loans outstanding to Asia are expected to continue falling. While this partly reflects less demand for credit, or more of it being met domestically, it also reflects ongoing caution by lenders about political uncertainties and the slow pace of restructuring in some countries.

## 5 Cyclical aspects of international bank lending

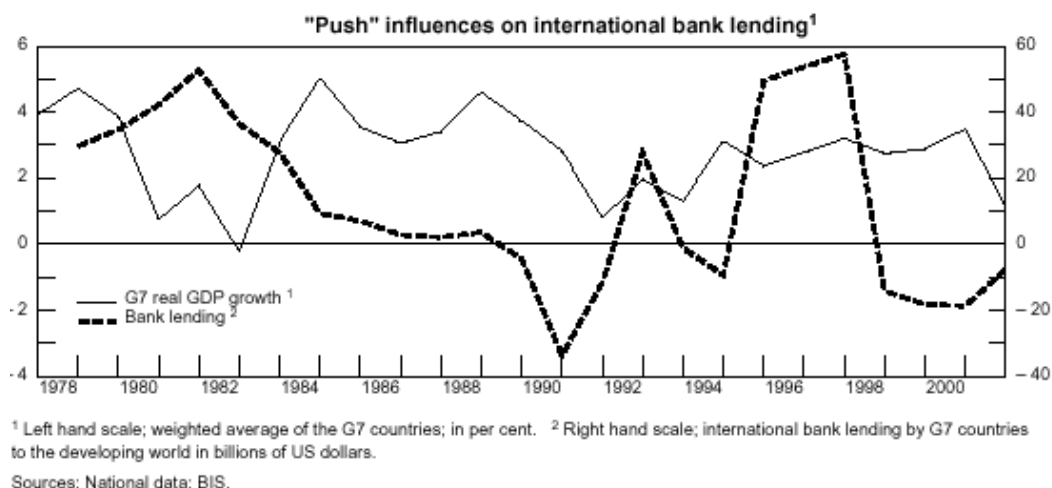
International bank lending to emerging economies is subject to both 'push' factors (in the source countries) and 'pull' factors (in the user countries). A simple comparison of three of these forces – the strength of the advanced and emerging economies, which might be associated with their respective expected returns, and interest rates in the advanced economies – are shown in Graphs 2, 3 and 4. In terms of the activity measures, the graphs suggest that the pull factor is generally stronger than the push, i.e. banks' lending is more responsive to conditions in the borrowing economies than in the lending economies, but there are some exceptions. The starkest example of this recently has been the sharp cutback in lending to Asian economies by Japanese banks after their domestic difficulties (Graph 5). It has been suggested that the push factor dominates in Latin America and the pull factor in Asia. In their survey of the literature Jeanneau and

Micu (2002) comment ‘some of the more recent studies have tended to emphasise the complementarity of push and pull factors, with the first set of factors determining the timing and magnitude of flows and the second set determining their geographic distribution’.

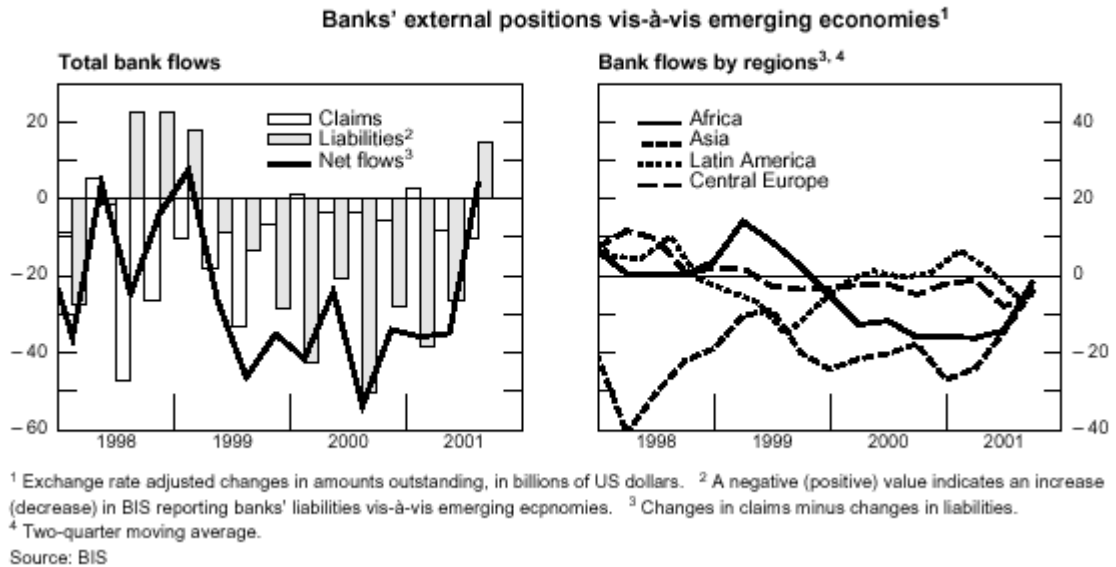
Graph 2



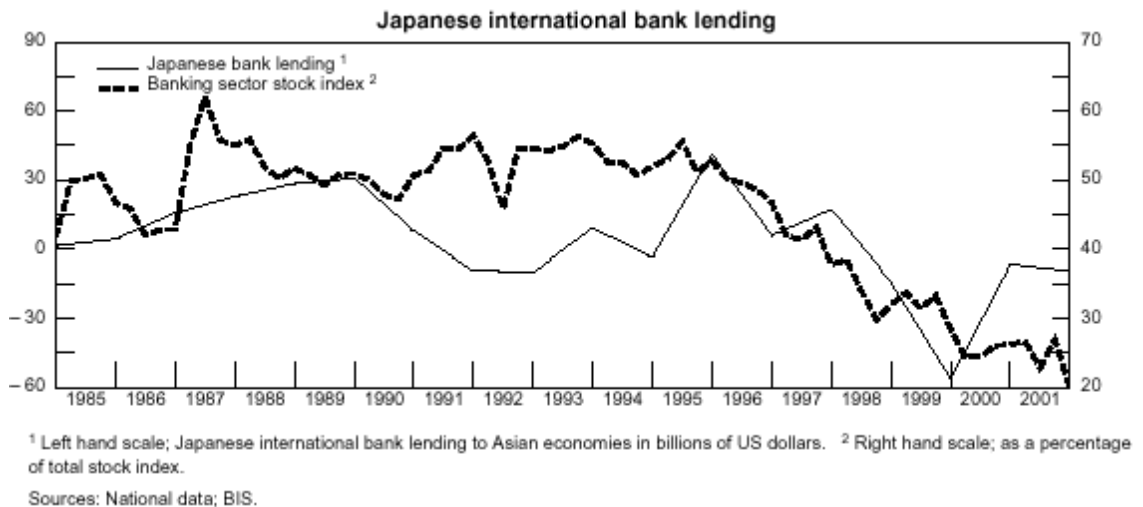
Graph 3



Graph 4



Graph 5



Jeanneau and Micu (2002) present their own empirical evidence, using the BIS banking data, that a push factor, real short-term interest rates in industrial countries, is the dominant influence (but real GDP in the lending countries does not have a significant influence). Of the pull factors, they also find a role for economic growth in borrowing countries, their exchange rate variance and changes in foreign reserves and the current account. The results were broadly similar for Asia and Latin America. Tests using a crisis dummy suggested that the Asian crisis had the effect of redirecting lending from Asia to Latin America. These factors explained more of short-term than long-term lending. It is noteworthy that the previously observed tendency for capital flows to emerging economies to rise when activity in the industrial world weakened is not happening in the current slowdown; all the signs are that flows are declining.

Interest rates in most advanced economies were low in the early 1990s (in the US partly due to the weakness of the banking sector at that time). This encouraged banks to seek out higher returns from lending to emerging economies. Interest rates stayed very low in Japan in the 1990s, giving rise to the ‘yen carry’ trade; borrowing in yen (at perhaps 0.5 per cent) and lending elsewhere in Asia (perhaps at 20 per cent in Indonesia). The sheer size of the interest rate differential, and the confidence in an Asian economic miracle, tempted lenders to ignore the exchange rate and credit risks involved. Another example where interest rates played an important role was the rise in US rates in early 1994 acting as an important trigger for Mexico’s subsequent problems. However, this also provides a counter-example as the interest rate increase seemed to do nothing to curb lending to the Asian economies.

Just looking at interest rates in advanced economies is, of course, very simplistic. The more relevant measure would be some risk-adjusted expected return. This should be compared with expected returns in emerging market economies. Furthermore, lending may not just respond to differences in expected return but also to the degree of variation and uncertainty about the return or the extent to which returns are correlated across countries and regions. Addressing these issues empirically is well beyond the scope of this paper.

The relative importance of push and pull factors will also depend on the extent to which banks are informed about individual emerging economies and discriminate between them. To test for this, the percentage change in outstanding claims of banks owned by the five main lending countries on the ten main emerging economies was calculated over six-monthly periods from June 1990 to June 2000. The correlations are shown in Table 7. There are quite a few negative correlations, suggesting that lending flows are not uniform but have many idiosyncratic features. It can also be observed that the correlations tend to be more similar across rows (borrowers) than down columns (lenders), again suggesting that pull factors are generally the more important.

Table 7  
Correlations between changes in claims of BIS-reporting banks on developing economies<sup>1</sup>  
June 1990–June 2000

Lenders	France	Germany	Japan	United Kingdom	United States	<i>Standard deviations</i>
<i>Borrowers/</i>						
China	0.08	0.01	0.11	0.12	0.01	0.1
Indonesia	-0.06	0.02	-0.04	-0.17	-0.03	0.1
India	-0.00	-0.10	0.33	-0.07	-0.08	0.2
Malaysia	-0.12	0.14	-0.32	0.09	-0.18	0.2
Korea	0.03	-0.20	-0.28	-0.10	-0.15	0.1
Thailand	-0.20	-0.37	-0.14	-0.33	-0.39	0.1
Argentina	0.51	0.25	0.10	0.90	0.12	0.3
Brazil	0.45	0.46	0.12	-0.03	0.11	0.2
Chile	0.42	0.19	-0.02	0.41	0.39	0.2
Mexico	0.03	0.06	0.14	-0.15	-0.30	0.2
<i>Standard deviations</i>	0.3	0.2	0.2	0.4	0.2	

<sup>1</sup>Correlation between percentage change in lending over six-monthly periods by banks owned by lending country *i* to borrower *j* with all loans to all developing economy borrowers.

In a similar study, but which focuses on periods of currency crisis, Van Rijckeghem and Weder (2000, 2001) use the BIS consolidated banking statistics to examine the role of bank lending in contagion. Noting the specialisation illustrated by Table 2, they test for a ‘common lender effect’. The hypothesis is that banks that make losses due to their exposure to a crisis country respond by cutting back lending to other emerging economies. As a result, emerging economies sharing lenders with a crisis economy suffer from contagion. They find evidence for such an effect after the Mexican and Asian crises but not after the Brazilian crisis. Given the pattern of common lenders shown in Table 2, this form of contagion is most likely to affect other economies in the same region. From a policy point of view, these findings imply that emerging economies could reduce their contagion risk by diversifying the sources of their funding and carefully monitoring their vulnerability through shared bank creditors. Notwithstanding the fact that the choice of creditors by private banks is the decision of individual banks, the authorities can still play a role by providing information on aggregate positions and also by adjusting the composition of their own creditors.

Some recent studies on determinants of the destination of bank lending are summarised by Buch (2000). For German banks, lending is highly correlated with trade links, although this does not appear to be ‘follow-the-customer’ behaviour as much of the explained lending is to banks, rather than companies, in the recipient countries. A study of OECD banks found market growth and diversification prospects were most important. In the US, small banks tend to follow the lead of large banks in their overseas lending. Buch’s own study uses the BIS data and finds international bank loans are greater to countries with trade links with the lender, strong growth in industrial production, membership of the OECD (assumed to reflect the corresponding lower capital requirements under the Basel accord) and geographically close to the lender. Capital controls deter lending. In addition, Spanish banks lent far more than these variables alone would predict to Spanish-speaking countries (the only case where common language appeared important). Interest rate differentials were not significant.

The international lending behaviour of individual US banks is studied by Goldberg (2001). As noted in Table 2 above, much of this lending is concentrated on Latin America, and Goldberg shows this is especially true of smaller banks. She concludes that US banks’ foreign lending to Latin America expands more when the US economy is growing strongly, but this is not the case for lending to Asia. However international lending by US banks is not sensitive to either real interest rates and demand conditions in the recipient emerging economies.

## **6 Structural aspects of international bank lending**

### **6.1 Changes in bank operations**

Global banks have been reducing their involvement in lending to emerging economies in favour of fee-based activities and lending via subsidiaries (Table 8). The move towards fee-based activities may be due to banks trying to meet aspirations for high returns on equity without adding assets to their balance sheet which would require more equity to be raised. It also may reflect a more conservative attitude towards taking risks onto their own balance sheets (possibly due to a greater appreciation of the extent of these risks) and a desire for more stable income sources.

Table 8  
International banks' involvement with developing countries

	June 1998 (US\$ bn)	Dec 2000 (US\$ bn)	Percentage change (at annual rate)
<i>All developing countries</i>			
Loans outstanding	924	739	-8.8
Other assets <sup>1</sup>	110	155	14.7
Loans by subsidiaries <sup>2</sup>	248	435	25.2
<i>Developing Asia</i>			
Loans outstanding	358	243	-14.4
Other assets <sup>1</sup>	36	41	5.3
Loans by subsidiaries <sup>2</sup>	72	118	21.8
<i>Latin America</i>			
Loans outstanding	278	213	-10.1
Other assets <sup>1</sup>	43	74	24.3
Loans by subsidiaries <sup>2</sup>	134	231	24.3
<i>Memo</i>			
International debt securities on issue	345	417	7.9

<sup>1</sup>Includes holdings of debt securities, some derivative positions and equities. See BIS (2000), part I.C.

<sup>2</sup>Local currency claims of BIS reporting banks' foreign affiliates with local residents.

Source: BIS.

Lending through subsidiaries may allow better quality control from lending officers located in specific emerging economies. It more readily allows international banks to lend in domestic currency, as a subsidiary can raise deposits in the domestic currency to avoid a currency mismatch resulting. In some countries (e.g. China, Malaysia) direct lending in domestic currency from the head office may be prohibited by capital controls.

In some cases, host bank supervisors prefer international banks to lend through such subsidiaries. Many emerging market economies are now encouraging the entry of foreign banks to make up for deficiencies in their domestic banking systems such as the lack of capital, the lack of commercial banking skills and an inefficient banking structure. Foreign banks usually bring state of the art technology and training for domestic bankers. Moreover, they are familiar with sophisticated financial instruments and techniques, and have faster and cheaper access to international capital markets and liquid funds. Their presence may also encourage other foreign firms to invest in the domestic economy. Empirical studies have found that foreign bank entry improves the functioning of national banking markets, both by increasing the degree of competition and by introducing a variety of new financial products and better risk management techniques.<sup>7</sup> Adopting a liberal approach to foreign bank entry has also been laid down by international trade agreements (WTO, NAFTA), or has been a condition of membership of the OECD or the European Union, or is part of reciprocity requirements for domestic banks to expand into foreign markets.

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<sup>7</sup> See e.g. Claessens and Klingebiel (1999). Claessens et al. (2001) show that significant foreign bank entry is associated with a reduction in both operating expenses and profitability of domestic banks.

As a result, foreign banks now have a large presence in most emerging economies. Indeed, for a small economy it may make sense not to have any domestically owned banks at all, as they may not be able to diversify their risks sufficiently. Nonetheless, in practice there are only a few economies with fully foreign-owned banking systems, with the degree of foreign ownership more normally lying somewhere between 20 per cent and 50 per cent.<sup>8</sup> While announcing a major liberalisation programme, the authorities in Singapore stated explicitly that they wanted local banks to retain at least half the market. Another example is the Philippines, where a law restricts the foreign banks' share of assets to under 30 per cent.

Foreign banks often enter by taking over a troubled domestic bank. However, there may be public resistance to this, especially if taxpayers' money has been used to clean up the bank's balance sheet ahead of privatisation. Governments also face domestic pressure to limit the role of foreign banks because of fears that foreign banks will quickly come to dominate the local market and neglect small business or rural customers, or lead to a lowering of credit standards by increasing competition, especially if they use their deep pockets to subsidise early losses. Evidence on whether the business focus of foreign and domestic banks diverges is rather mixed. In most emerging market economies, however, foreign banks appear very cautious about lending to smaller firms because of their limited knowledge of local industry.

An important issue has been foreign banks' behaviour during recessions in host countries and the foreign banks' home base. One opinion is that domestic banks are more committed to the domestic economy, in the sense of having both longer-term business relationships with customers and a patriotic affinity with the national interest. Foreign banks, by contrast, are said to look at lending opportunities around the world and may neglect the host country economy if its prospects deteriorate or if prospects improve in other countries. Foreign banks may also be less likely than domestically owned banks to heed exhortations by the domestic authorities to maintain lending during recessions. In some cases, foreign banks have been less cooperative in rescheduling loans in times of crisis. It is difficult to assess the truth of these criticisms. They may well apply more to foreign banks with only a small and recent presence in the domestic banking system. However, larger, longer-established foreign banks may be less inclined to risk their reputation and behave more like the domestic banks. There is also evidence that local management is usually strongly committed to the local operation, and that they come to identify more with domestic interests over time.

The contrary opinion is that foreign banks are better placed to ride out domestic recessions because they can more readily access international financial markets or draw on credit lines from their parents. Furthermore, they have better diversified balance sheets. The empirical evidence from Latin America suggests that foreign banks have generally had lower volatility of lending than domestic banks and notable credit growth during crisis periods, and that only offshore lending tended to contract in bad times.

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<sup>8</sup> Very high rates of foreign bank penetration occur, for example, in New Zealand (91 per cent), Botswana (94 per cent), Jordan (95 per cent), and Bahrain (97 per cent). A rare case where this issue is being addressed from scratch is the world's newest nation of East Timor. The economics minister was reported as preferring not to have any domestic banks but another senior politician found it hard to imagine a nation without at least one domestic bank (*The Economist*, 2 September 2000). For data on shares of foreign banks in banking assets, see Table 9 in Hawkins and Mihaljek (2001).



Foreign bank operations may also keep international markets better informed about domestic conditions and so help dampen panic withdrawals of international funding (as in Saudi Arabia during the Gulf war), or can help reduce resident capital outflows during crises because they are usually perceived as safer.

Governments may also be reluctant to have their domestic banking systems dominated by banks from a single country, in case they suddenly cut their activities when faced with problems at home (e.g. Japanese banks in Asia), or are able to exert political pressure for favourable treatment. For this reason, the emerging economies may seek to 'diversify' foreign owners. For example, the Saudi authorities have been selective and licensed foreign banks from different parts of the world, with different management cultures, systems and technologies. Similarly, the authorities in China have been concerned about the impact of foreign banks on the competitiveness of domestic banks, and have sought to limit their market share by licensing banks from different countries, and by restricting their activities to doing business in foreign currencies only, or to doing business in local currency in only two cities. They have also ensured that banks have more familiarity with the local market by requiring them to have a representative office for two years before commencing banking operations.

## **6.2 Policy towards international bank lending**

Since the Asian crisis there is a greater awareness by policymakers of the risks involved in excessive external borrowing. Supervisors may therefore discourage banks from borrowing offshore and restrict their foreign exchange exposure.<sup>9</sup> However, sometimes banks try to restrict their own foreign exchange exposure by lending in foreign currency to domestic customers whose cash flows are in the domestic currency. However, they then face a large credit risk if there is a sharp depreciation. This was a major problem in both the Mexican and Asian crises in the 1990s.

In some countries restrictions have been placed on international bank financing, such as recent tightening of limits on non-residents' ability to borrow domestic currency (Indonesia, the Philippines and Thailand). Often these have been directed at activities such as non-residents short-selling the currency as part of a speculative attack, but the restrictions may reduce lending for other, more innocent, purposes as well.

## **6.3 International bank lending and the Basel capital accord**

The Basel Committee on Banking Supervision is currently in the process of adapting the Basel Capital Accord to new market realities. It has issued two consultation drafts (June 1999 and January 2001). This could have implications for the quantity or distribution of bank lending to emerging economies; some argue banks are already reacting to the proposals.

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<sup>9</sup> The Financial Stability Forum's (2000) report on capital flows suggests that in emerging economies where supervisory resources are scarce, simple restrictions on banks' foreign exchange exposures might be used for a time until a more sophisticated risk management approach is feasible. These rules could include limits on long or short positions relative to capital, minimum holdings of liquid assets, and reserve requirements. Foreign currency loans could be restricted to a fixed percentage of capital or banks could be required to hold more capital against these loans.

A primary goal of the proposals is to align more closely the capital required to support a loan with its risk. In particular it replaces the OECD/non-OECD distinction with an approach based on banks' internal credit ratings or those set by credit assessment agencies. This means at the margin that loans to lower-rated OECD economies such as Korea, Mexico, Poland and Turkey would require more capital while loans to higher-rated non-OECD economies such as Chile, Hong Kong and Singapore would require less.

Risk weights for banks and corporates would also be dependent on their credit ratings. This should reduce funding costs for some of the soundest banks and companies in emerging economies. The lower risk weights assigned to corporations rated A- or better may lead to more lending to them at the expense of weaker credits. As the weaker credits tend to be more prevalent in emerging economies, this could reduce the overall flow of bank lending to emerging economies. It may well be in emerging economies' interests for the riskiest borrowers to find credit more expensive, but there are some concerns – for example by Griffith-Jones and Spratt (2001) – that the mapping between credit assessments and capital required is excessively steep so that the lowest-rated borrowers would find loans from banks prohibitively expensive. A particular problem for corporate borrowers in many emerging economies is that few of them have a credit rating; e.g. Powell (2001) reports that in Argentina only 150 of 80,000 corporate borrowers are rated.

The new accord envisages the more sophisticated banks using an advanced internal ratings-based (IRB) approach. This may reduce the extent of herding if it leads banks to make loans based on individual assessments of countries.<sup>10</sup> However, the proposed role for external credit assessment agencies (not just ratings agencies but also national export credit agencies) has led to some concern. Sovereign ratings have tended to lag economic developments, as ratings agencies have been slow to downgrade countries pre-crisis, when underlying imbalances are building up and warnings would be useful to both borrowers and lenders, and then put a country through several downgrades once a crisis has broken out. This may make them a pro-cyclical element (as they were during the Asian crisis), encouraging banks to withdraw even further from emerging economies just when their support is most needed. However, it is not clear what would be a better alternative. Sovereign credit spreads tend to be even more volatile than ratings. One approach would be to adjust regulatory risk weights only gradually in response to changes in credit ratings. Financial markets are likely to be pro-cyclical regardless of how regulations are structured. Hopefully, a greater focus on measuring risk in both banks and their supervisors will mean a more careful and less short-term focus.

Under the present Accord, international inter-bank lending of up to one year to non-OECD economies has a 20 per cent risk-weight while longer-term lending carries a 100 per cent risk weight. One possible consequence of this distinction is that bank lending to emerging markets is 'too' short term, and thus more subject to cyclical forces.<sup>11</sup> While a lower risk weight for short-term lending than for long-term lending may make sense for

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<sup>10</sup> Such independence becomes less likely if banks use the same credit risk models and rely on the same database to quantify credit losses.

<sup>11</sup> While it is reasonable for borrowers to pay more for longer-term loans, the premium may be driven too high if capital requirements are inappropriate.

the lending of an individual bank (which is the focus of the supervisors), it makes less sense if *all* banks lend short-term so that the borrower is vulnerable to a sudden loss in liquidity. In other words the systemic (or macro) considerations may to some extent run counter to supervisory (or micro) considerations.

The current consultative document issued by the Basel Committee (2001) recognises the potential for ‘unintended consequences on lending markets’ from setting lower capital requirements for short-maturity loans and is seeking comments on this question. It suggests lowering the threshold for preferable treatment of short-term debt to three months, the upper maturity band in the inter-bank money market. While the proposed risk weights for short-term lending to banks rated between A+ and B- are lower than those applied to long-term loans to those banks, the difference is 30–50 percentage points rather than the current 80 percentage points.

## 7 Conclusions

Since the Asian crisis, funds have consistently flowed *to* international banks *from* emerging economies. Previously, this would have seemed as likely as water flowing uphill. There are a number of factors responsible for this surprising event, both cyclical and structural:

- Initially, the Asian crisis came as a shock to complacent banks who had assumed the good times in Asia would extend indefinitely and ignored mounting debt in the region. Subsequently the Russian crisis weakened the conviction that lenders to important countries would always be bailed out. This has led to reduced lending.
- Some complacency was also removed from borrowers in emerging economies. Many borrowers became keen to repay debt. In Asia, currency devaluations and strong demand (until recently) for their electronic exports allowed them to repay excessive debt.
- Cyclical factors played some role; until recently growth prospects in the US were seen as exceptionally strong. Growth prospects looked poorer in damaged Asian economies, Argentina, Brazil and Turkey. Many Asian economies have a legacy of over-investment so are not keen to borrow.
- Deposits with international banks by emerging market economies have been growing, reflecting variously deregulation of fast-growing funds managers, capital flight and saving of high oil revenues.
- A structural change exaggerating the phenomenon is that increasingly, encouraged by policy makers, banks are doing their lending in emerging economies through subsidiaries there, using deposits raised there, rather than from head office.

It is hard to apportion the turnaround in international bank lending between these factors. But there is a risk that instead of problems of excessive capital inflow the emerging economies will face a problem of inadequate inflows. The water flowing uphill will move them from a flood to a drought.

## Annex A

### BIS international banking statistics

Data are gathered quarterly from national authorities, usually central banks, in 28 economies, including the world's main banking centres.<sup>12</sup> There are two main quarterly collections, known as the locational and consolidated collections.

The *locational* data, which commenced in 1964, are consistent with balance of payments principles and refer to banks, both domestic and foreign-owned, located within the 28 economies (but *not* their overseas subsidiaries). The data refer to banks' international banking business, defined as gross financial claims or liabilities vis-à-vis non-residents as well as foreign currency positions vis-à-vis residents. To minimise reporting burdens the collection was built on existing national data collections. Although it usually covers well over 90 per cent of international lending, there is some variation in the coverage of institutions, and some definitional inconsistencies.<sup>13</sup>

The assets and liabilities (and a narrower concept of loans and deposits) are broken down by;

- currency, into domestic, US dollar, euro, yen, sterling, Swiss franc and 'other'. One reason is to measure the extent to which changes in stocks expressed in US dollars are attributable to valuation effects arising from exchange rate fluctuations rather than due to transactions.
- sector, into banks and non-banks; and
- economy (with international organisations such as the IMF, OPEC etc included as a special 'country' rather than allocated to the country where they are headquartered.).

A snapshot summary of these data, which are published for over 160 individual emerging economies, as of end-2000 is provided in the upper part of Table A1. For some countries there are significant discrepancies between the data published by the BIS based on information from lenders and the external debt statistics published by national statistical agencies based on information from borrowers. In some cases this is known to be due to definitional differences rather than any misreporting.<sup>14</sup>

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<sup>12</sup> The economies are Australia, Austria, Bahamas, Bahrain, Belgium, Canada, Cayman Islands, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Luxembourg, Netherlands, Netherlands Antilles, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, Turkey, United Kingdom and the US.

<sup>13</sup> Some countries include the banking operations of their central bank and some only provide data on banks operating in their offshore banking centres. Some countries only provide a restricted foreign currency breakdown. Differences exist between countries in the definition of a bank. Accounting differences may affect the basis on which the value of securities are reported and the treatment of interest arrears.

<sup>14</sup> The treatment of trade credits is one such area. See Kertudo et al. (2001) and FSF (2000) for a further discussion of the differences between creditor and debtor data.

The consolidated collection, launched in 1977 but reported only semi-annually until end-1999, is focused on banks' worldwide credit and country risk exposure and is gaining more emphasis. It gives information on banks' international lending activities broken down by maturity, sector and borrowing country on a world-wide *consolidated* basis. Banks with head offices in the reporting country provide information for all their offices at home and abroad (including any operations in which they own more than 50 per cent of the capital) with positions between different offices of the same bank netted out. Examples of these data, are provided in the lower part of Table A1. The collections also include separate reporting of foreign banks' local business in local currency, a growing item due to international banks' purchases of domestic banks in emerging economies.

Table A1  
BIS reporting banks' exposure to developing countries  
US\$ billion, end 2000

	Total	Of which:			
		Asia-Pacific	Europe	Latin America	Mid-East & Africa
Assets	905	285	174	295	152
of which: loans	753	243	143	226	142
of which: to non-bank sector	395	107	75	139	74
Liabilities	1051	360	124	252	315
of which: deposits	1044	359	123	246	315
of which: to non-bank sector	420	141	33	123	123
Consolidated claims	860	284	172	283	123
of which: short-term	412	134	71	138	69
of which: on public sector	146	36	28	58	25
on non-bank private sector	449	142	75	172	61
Unused lines	138	42	27	32	37
Affiliates' local currency claims on local residents	340	103	43	173	21

Source: BIS.

## Improvements

The BIS data collections are being continuously improved in terms of accuracy, coverage and timeliness. Likely improvements within the next two years include adding reporting by 4–6 more developing countries and offshore centres to both the international banking statistics, a country breakdown for the derivatives business of banks and more detailed data on an ultimate risk basis. The improvements are overseen by the Committee on the Global Financial System and an expert group of central bank statisticians (see Fender and Frankel 2001).

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