Franziska Bremus and Katja Neugebauer (2017): 
Reduced Cross-border Lending and Financing 
Costs of SMEs

Discussion

Julia Schmidt (BdF)
Financial structure, financial stability and the economy
Paris, 20 October 2017
Summary of paper

- Investigation of link between cross-border bank lending and borrowing costs.
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- Most literature looks at impact of capital flows on domestic credit growth, but not at its cost!
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Findings:

- Reductions in cross-border lending are associated with higher interest rates for SMEs.
- This only holds for reductions in cross-border lending to banks, but not to non-banks.
Are foreign banks / cross-border bank inflows good for the host economy?

- Yes (in normal times):
  - More competition and lower costs
  - Increased access to financial services
  - Better financial and economic performance of their borrowers
  - Greater financial stability

- In crisis times: ...depends, but largely no.
  - "Flight home" effect
  - Affiliates support constrained parent banks
  - Parent banks support constrained affiliates
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Euro area: fragmentation

Bank interest rates – loans to corporations, maturity < 1 year
Euro area: fragmentation

• Fragmentation = loan interest rates in stressed markets far above those in the core.
  • Despite low policy rates, interest rates for corporate loans are high.
  • Credit channel of monetary policy is impaired
    → balance sheet channel (borrowers' balance sheets)
    → bank lending channel (supply of loans by banks)
• Central bank policy can influence supply of loans: LTROs
  • Do results imply that LTROs were simply not enough?
  • Disentangling demand effects (borrowers’ balance sheet weaknesses) from bank supply effects
  • Need to quantify the rise in interest rates that is due to bank supply shocks (because this is where central bank liquidity provision can help out)
What drives interest rate increases?

- Tight monetary policy: +
- Supply shocks (banks): –
- Demand shocks (firms): +
- Macroeconomic risk: –
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- Tight monetary policy: +
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- Demand shocks (firms): +
- Macroeconomic risk: −
Endogeneity / identification

Supply shocks

• If capital inflows from abroad are considered exogenous, there are two main channels:
  • Direct channel: cross-border credit to non-financial firms
  • Indirect channel: cross-border credit to banks changes supply of bank credit to firms

• Why is the indirect channel at work, but not the direct channel?

<table>
<thead>
<tr>
<th></th>
<th>International credit to non-banks</th>
<th>International credit to banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-0.124</td>
<td>-0.069***</td>
</tr>
<tr>
<td></td>
<td>(0.077)</td>
<td>(0.023)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-0.089</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.072)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-0.064***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.021)</td>
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</table>

• Direct cross-border loans do not go to SMEs?
Endogeneity / identification

Supply shocks

- Exogeneity of capital inflows:
  - Usually assumed for emerging/developing economies, but not for industrialized economies
- Difficult to claim exogeneity in the case of euro area:
  - Cross-border bank inflows are largely originating in euro area.
  - The same factors that drive a reduction of inflows in Spain lead to an increase of inflows into Germany.
Endogeneity / identification
Macroeconomic risk: Credit rationing?

• “Increasing loan rates should make it more attractive for banks to lend.”

• Yes, but imagine:
  • Higher interest rates driven by increase of aggregate macro risk
  • Proportional shift in riskiness of borrowers
  • Interest rates rise proportionally across all firms
  • Credit rationing à la Stiglitz and Weiss (1981) due to higher probability of default
  • Less supply of credit, even when interest rates rise, and thus less funding from abroad

• Is the drop of cross-border inflows a cause or a symptom?
Endogeneity / identification

Demand

• Need to properly control for demand.
  • Paper: include dummy on whether banks face problems finding costumers

• What does the literature usually do?
  • Loan volume as a function of supply and demand factors:

\[ L_{b,f,t} = \alpha_1 S_q + \alpha_2 S_{b,t} + \beta_1 D_t + \beta_2 D_{f,t} + \ldots \]

  • \( S_t \): Economy-wide supply factors, i.e. monetary policy
  • \( S_{b,t} \): Bank-specific supply factors, i.e. wholesale market funding shock
  • \( D_t \): Economy-wide demand factors, i.e. rise in uncertainty or fiscal policy shock
  • \( D_{f,t} \): Firm-specific demand factors, i.e. productivity shock

• Coefficient of interest is usually: \( \alpha_2 S_{b,t} \)

• Estimation of \( \alpha_2 \) when demand cannot be observed:

\[ \hat{\alpha}_2 = \alpha_2 + \beta_2 \text{cov}(S_{b,q}, D_{f,t}) / \text{var}(S_{b,t}) \]

• Khwaja and Mian (2008): \( f,t \)-FE take care of \( S_t, D_t \) and \( D_{f,t} \)

\[ L_{b,f,t} = \lambda_{f,t} + \alpha_2 S_{b,t} + \varepsilon_{b,f,t} \quad (\geq 2 \text{ banks per firm}) \]
Why limit the analysis to cross-border extra-group flows?

- Intra-group flows are very important for EA banks.

Cross-border positions, FR, locational data, 2014Q1, in bn EUR

<table>
<thead>
<tr>
<th></th>
<th>Claims</th>
<th>%</th>
<th>Liabilities</th>
<th>%</th>
</tr>
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<tbody>
<tr>
<td>All sectors</td>
<td>1707.4</td>
<td>100</td>
<td>1332.8</td>
<td>100</td>
</tr>
<tr>
<td>Banks</td>
<td>1155.7</td>
<td>67.7</td>
<td>1076.3</td>
<td>80.8</td>
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<td>Banks, intra-group</td>
<td>465.3</td>
<td>27.3</td>
<td>415.3</td>
<td>31.2</td>
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<td>Banks, extra-group</td>
<td>690.4</td>
<td>40.4</td>
<td>661.0</td>
<td>49.6</td>
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Lending by affiliates abroad is maybe the more policy-relevant issue?

Foreign loans, FR–big 6, consolidated data, mean 2006Q4–2013Q2

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Claims vs. liabilities

Int'l claims and liabilities, France, consolidated data, stocks
Claims vs. liabilities

Int’l claims and liabilities, Italy, consolidated data, stocks
Conclusion

- Very nice and clear paper.
- Focus on price effects.
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- Very nice and clear paper.
- Focus on price effects.
- What are the economic mechanisms at play?
- Quantification would be nice.
- Policy conclusions?