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| **Domestic financial regulation and external borrowing**[Sergi Lanau](http://www.voxeu.org/index.php?q=node/6765)19 July 2011, VOX.EU*The global crisis has forced a root-and-branch rethink of financial regulation. This column discusses the international dimensions. It presents new evidence to suggest that non-banks tend to borrow more abroad when domestic regulation is tight.*An extended global credit boom was one of the defining features of the 2000s and possibly one of the major causes of the crisis. In many major economies, banks’ balance sheets expanded rapidly and lending to the private sector skyrocketed.Policymakers might control these credit booms through an improvement in bank regulation (Brunnermeier et al 2009, King 2009). To shed some light on the international dimension of the regulatory debate, my research ([Lanau 2011](http://www.bankofengland.co.uk/publications/workingpapers/wp429.pdf)) explores the empirical link between domestic financial regulation and non-banks’ borrowing from foreign banks.This is an important area of financial activity. A positive and significant relationship between domestic regulation and borrowing from foreign banks would suggest that cross-border regulatory measures can play a role in determining leverage and should thus be part of the reform agenda. This possibility has been discussed in the policy literature (Ocampo 2002) but not formally tested.I take a “locational” approach to the question and define foreign borrowing as loans taken out by resident non-banks from non-resident banks. (This is consistent with the balance of payments methodology). I derive my results under a gravity equation where country-level bilateral foreign borrowing by non-banks is the dependent variable and a measure of financial deregulation in the borrowing country is the key independent variable. The Bank for International Settlements’ banking statistics are the source for foreign borrowing data from the late 70s onward. I rely on Abiad et al. (2008) for the financial deregulation variables.Using a generic index of financial deregulation, I find that, all else equal, non-banks borrow more from foreign banks under tighter domestic financial regulation. More specifically, a country on the upper quartile of the deregulation index distribution borrows 20% more than a country with the lightest regulation. I then establish which components of the generic deregulation index are driving my results. The imposition of interest rate controls and entry barriers to the banking sector have a positive and significant effect on foreign borrowing. For example, the adoption of branching restrictions increases foreign borrowing by 15%. Bank privatisation also has a positive impact on foreign borrowing by non-banks. In contrast, credit controls, the adoption of Basel standards and the development of bank supervisory agencies do not have a significant effect on foreign borrowing. Importantly, the results also hold for the subsample of advanced economies.These results indicate that international borrowing and lending is a prominent element to be taken into account in designing financial-stability tools. Under an open capital account, the effectiveness of exclusively domestic regulation could be limited by the substitution of external finance for domestic loans. This underlines the importance of delivering on the recent G20 and Financial Stability Board pledges to achieve global coordination in financial policies (Obstfeld and Rogoff 2009 and Bank of England 2009 have also called for increased coordination). For instance, coordinated restrictions on the creation of external assets by banks would potentially smooth credit cycles driven by foreign borrowing.ReferencesAbiad, A, E Detragiache, and T Tressel (2008), “A new database of financial reforms”, IMF Working Paper 08/266.Bank of England (2009), “[The role of macroprudential policy](http://www.bankofengland.co.uk/publications/other/financialstability/roleofmacroprudentialpolicy091121.pdf)“, Bank of England Discussion Paper.Brunnermeier, M, A Crockett, C Goodhart, A Persaud, and H Shin (2009), “The fundamental principles of financial regulation”, *Geneva Reports on the World Economy 11*.King, M (2009), Speech at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June.Lanau, S (2011), “[Domestic financial regulation and external borrowing](http://www.bankofengland.co.uk/publications/workingpapers/wp429.pdf)“, Bank of England Working Paper 429Obstfeld, M and Rogoff, K (2009), “Global imbalances and the financial crisis: products of common causes”, paper prepared for the Federal Reserve Bank of San Francisco Asia Economic Policy, Santa Barbara, CA.Ocampo, J A (2002), “Capital account and countercyclical prudential regulations in developing countries”, United Nations University Discussion Paper 2002/82. | [**Print**](http://www.voxeu.org/index.php?q=node/6766)   [**Email**](http://www.voxeu.org/index.php?q=forward&path=node/6766)[**Comment**](http://www.voxeu.org/index.php?q=node/6766#comments)   [**Republish**](http://www.voxeu.org/index.php?q=node/87)  |

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