Destination of Global Liquidity and Role of Foreign Banks

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When funding conditions for banks across the globe are extra-ordinary loose, or when global liquidity expands, which countries is the global liquidity headed for? This paper examines empirically this question.

Our conjecture is that one of the key determinants of the destination is foreign banks' penetration rate in the host country's banking system, captured by share of foreign owned banks' assets to total bank assets. As for cross-border lending, informational asymmetry between lenders and borrowers is more severe, except in the case of intra-group lending between parent banks and foreign affiliate banks. This implies that if a bank in country X has foreign affiliates and/or branches in country Y, but does not have them in country Z, a large fraction of cross-border credit by the bank in country X might be extended to country Y while only a small fraction is extended to country Z.

We test this hypothesis by running cross-sectional regressions using data from 99 developed and emerging economies. The dependent variable is cumulative net inflows of bank-to-bank cross-border credit to an individual country from the second quarter in 2004 to the first quarter in 2008, calculated from the Locational Banking Statistics of BIS. The independent variables include a set of host country's *ex-ante* variables like foreign banks' penetration rate in its banking system in 2004, average real GDP growth rate in the preceding five years before 2004, regional dummies, and so on.

Our main findings are two-fold. First, during the global liquidity surge period in mid 2000s, the global liquidity flowed more into countries whose banking systems had been more penetrated by foreign banks. This finding is consistent with "flight abroad effect" in international syndicated loan market and with massive utilization of internal cross-border funding by parent banks of global banking groups during the global financial crises.

Second, the destinations of global liquidity during mid 2000s are unevenly distributed in a specific region; EU member states were the main receivers of global liquidity, while Sub-Saharan Africa is the region who received it least. This suggests that the expression of "global" liquidity might be misleading.

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