

Geopolitics meets monetary policy: What does cross-border bank lending data reveal?

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Fragmented World, Integrated Markets: Managing Systemic Geopolitical Risk panel

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Based on BIS WP 1247 “Geopolitics meets monetary policy: decoding their impact on cross-border bank lending”

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Identification

- Difficulty: monetary policy makers in a given country may respond to their country's evolving geopolitical tensions with other states
- Strategy: use **currency dimension of international bank lending channel**
 - Monetary policy affects lending denominated in a currency even when neither the lender nor the borrower uses that currency as its own, e.g. German banks' USD loans to borrowers in Malaysia (Takats & Temesvary, JIE, 2020)
- Implementation: Interact changes in
 - **monetary policy by the currency issuer** and
 - **bilateral geopolitical tensions** across the source lending banking system and borrowers' countries,

And apply extensive fixed effects to control for credit demand and credit supply

Three measures of geopolitical risk and tensions

- Bilateral UN voting disagreement
- Bilateral sanctions
- Geopolitical risk index

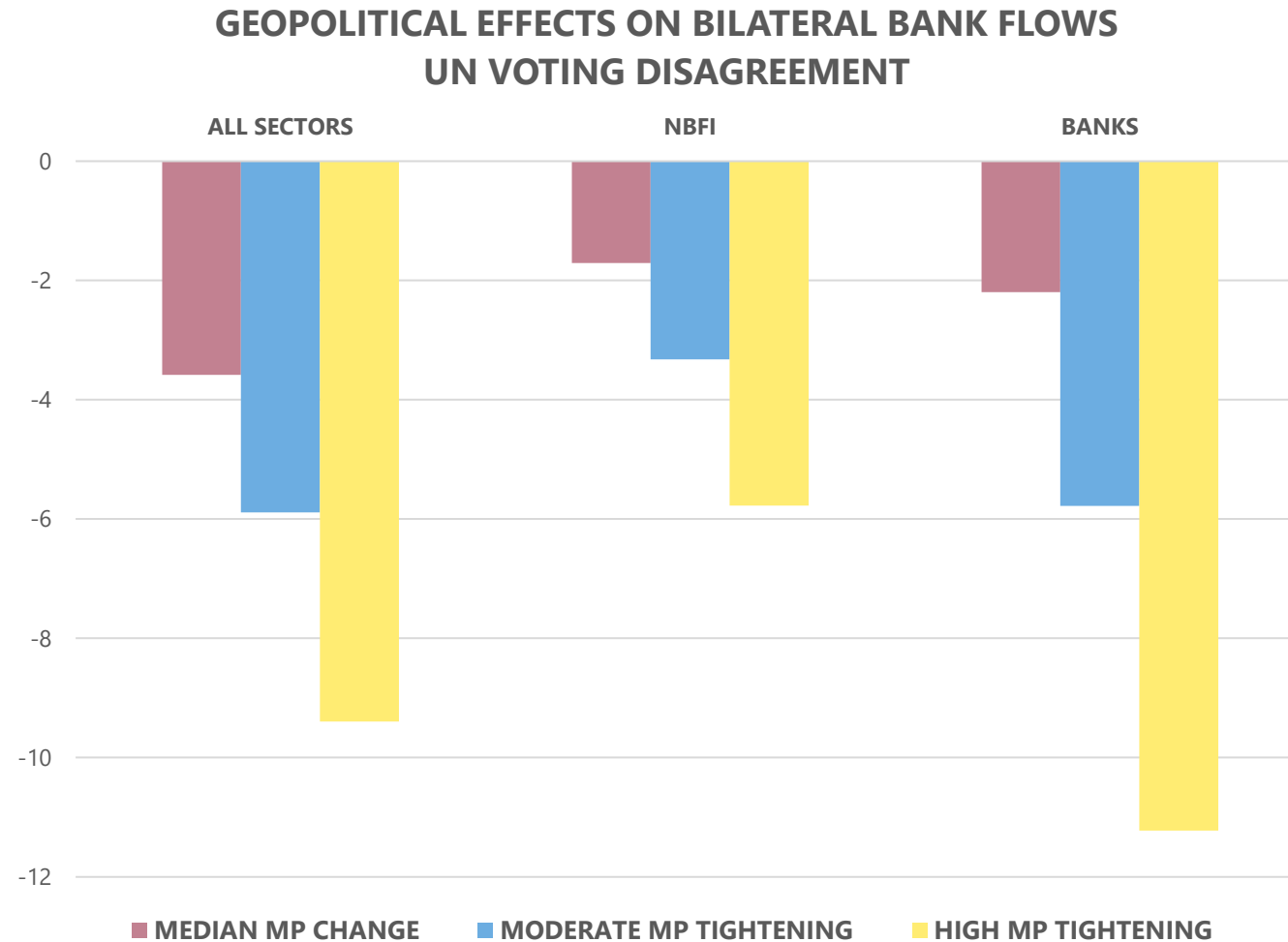
Panel regression setup: Benchmark

- Difference-in-differences regression (Takats & Temesvary, JIE, 2021):

$$\Delta claims_{ijct} = \sum_{k=1}^4 (\delta_{1k} \Delta monetary_{ct-k} * \Delta GeoPol_{ijt-k} + \delta_{2k} \Delta monetary_{ct-k} + \delta_{3k} \Delta GeoPol_{ijt-k} + \delta_{4k} Controls_{i/j/c/t}) + FE_{i/j/c/t} + \eta_{ijct}$$

- $\Delta claims$: log change in bilateral stocks (claims growth) from lending banking system i to borrowers' country j in currency c in quarter t
- $\Delta GeoPol$: change in bilateral geopol. measure between i and j in t
- $\Delta monetary$: change in Krippner shadow rate of currency c issuer in t
- $Controls$: Central bank policy rate (source), exchange rate changes (source, currency and borrower), fiscal deficit and debt (source)
- Examine changes over 4 quarters (~MP transmission over one year)

UN voting disagreement, policy tightening and lending



Geopolitics affects monetary policy transmission

- **Higher geopolitical tension across countries lowers cross-border lending**
 - E.g. increase in geopolitical tensions between Germany and Russia lowers cross-border lending by German banks to borrowers in Russia
- **Higher geopolitical tension across countries amplifies the transmission of monetary policy** into cross-border bank lending
 - E.g. worsening tensions between Germany and Russia amplify the negative impact of tighter US MP on German banks' USD lending
 - Double whammy: Interaction effects are strongest when worsening geopolitical tensions coincide with tightening monetary policy
- **Magnitudes comparable to those of a monetary policy tightening**
 - Material deterioration in global geopolitical relations can lower cross-border bank lending by \$1 trillion

Contribution to the variation of cross-border lending

- Our findings help understand the variance of banking flows:
 - A surge in geopolitical tensions amplifies variation in flows induced by changes in major central banks' monetary policy
 - Elevated volatility—assuming a one-time geopolitical shock—is not persistent
 - Focusing on variation in flows not explained by fixed effects:
 - **Geopolitics explains around half of variation**
 - **Monetary policy explains about 30 percent of variation**
 - **Geopolitical-monetary interactions explain ~ 20 percent**

Thank you for your comments!

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