

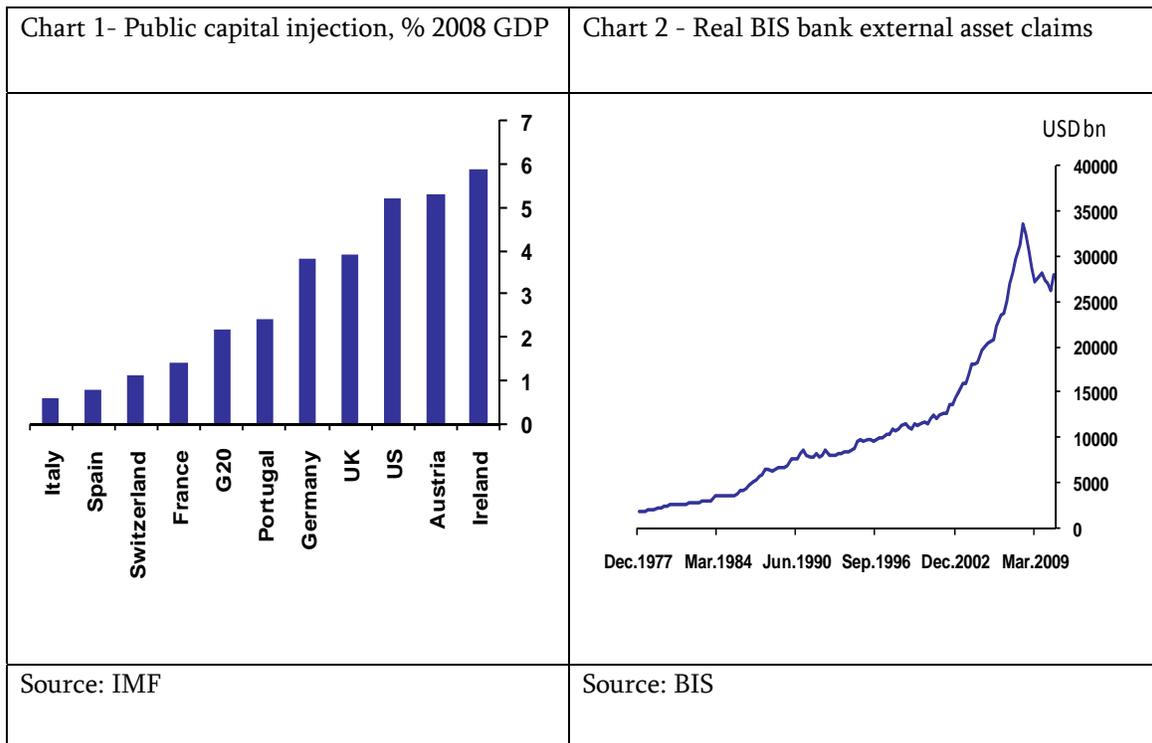
Financial Protectionism

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The “Great Recession” which engulfed the world in 2008-09 is frequently compared to the Great Depression of the early 1930s. Many economists blame trade protectionism for deepening, spreading, and/or lengthening the Great Depression, especially given the dramatic decline in trade during the Great Recession ([Eichengreen and O’Rourke, 2010](#)). This time around, there is only muted evidence of traditional trade protectionism, at least thus far. But the public sector has made substantial interventions in financial markets around the world, particularly in the banking sector (Chart 1), while cross-border bank lending has fallen globally (Chart 2). In a recent [working paper](#) we show that the two phenomena may well be linked; international lending may have fallen because of public interventions in the financial sector. More specifically, we ask: “Have bank nationalizations reduced foreign lending disproportionately?” The answer is positive, and we interpret this as evidence of financial protectionism.



We define financial protectionism as a nationalistic change in banks' lending behaviour, as the result of public intervention, which leads domestic banks either to lend less or at higher interest rates to foreigners (or both). Our objective is to test for financial protectionism empirically (there is no theory of relevance). The aggregate British data series lends *prima facie* plausibility to the idea that lenders cut back more dramatically on their cross-border activity than on their domestic activity. Chart 3 plots the growth of lending to British business over the past few years. The superficial impression one gets is that during the Great Recession, foreign lenders (taken to mean banks with headquarters outside the UK) contracted their activity more dramatically than British lenders (banks with headquarters in the UK). But such aggregate evidence provides at most indirect support for the presence of financial protectionism. Only if foreign *public* institutions contracted their British loans more than foreign *private* institutions, would we have strong *prima facie* evidence of financial protectionism.

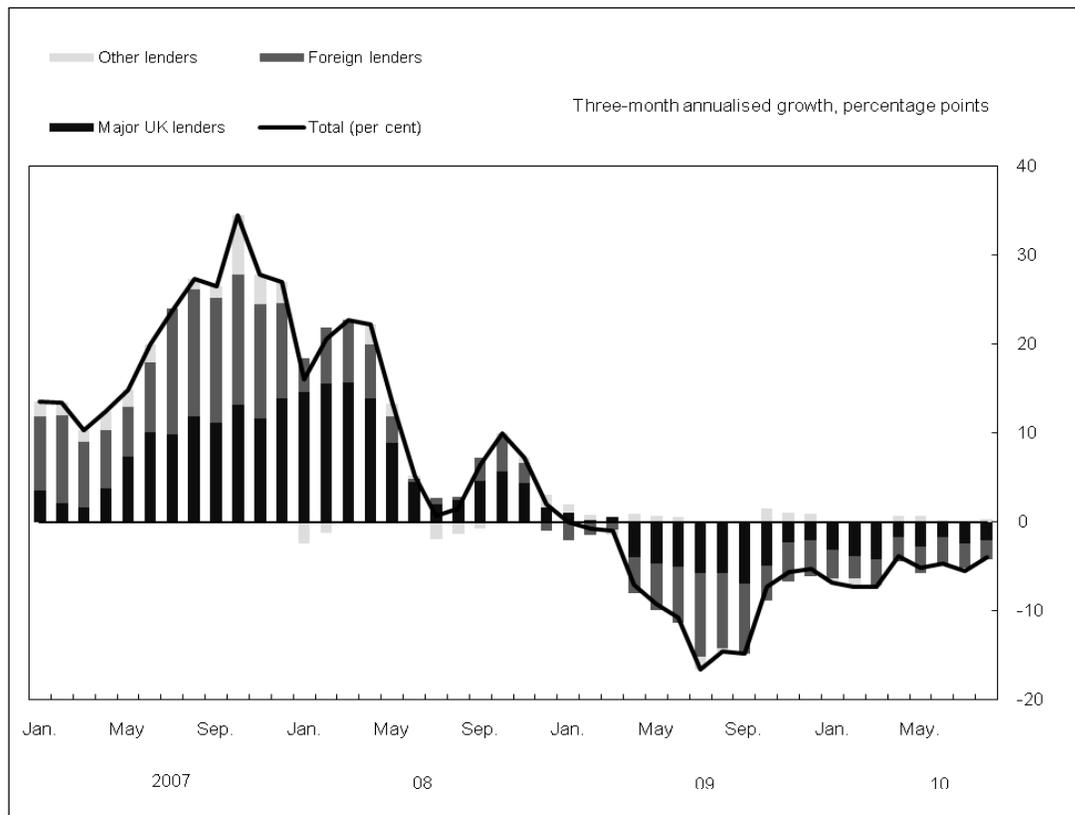


Chart 3: Contributions to Growth in Lending to UK Businesses

(Monetary financial institutions' lending to private non-financial corporations.

Three-month annualised growth rates in the stock of lending.)

Unfortunately publicly available datasets typically do not provide sufficient information to rigorously test for financial protectionism.¹ In this study, we take advantage of a panel data set on external and domestic lending collected by the Bank of England.² This data set covers all banks operating in the UK, both British and foreign and is a reliable data set much used by the Bank of England. The data set spans 1997Q3 through 2010Q1, a period characterized by the most significant international financial

¹ The Bank of International Settlements provides data on aggregate external lending among banking systems, but there is not breakdown between the lending decisions of nationalized and private institutions. Similarly, publicly available data at the institution level does typically not provide information on external lending.

² We would like to thank Mark Robson for permitting us to use the data in this study. For assistance with the data, we thank: Kiman Bassi, Eleanor Broughton; Mhairi Burnett; Martin Cleaves; Norbert Janssen; David Osborn; Jeremy Rowe; Jake Staines; and Martin Udy.

crisis in decades, during which a number of British and foreign banks were nationalised or supported with capital injections and/or loan guarantees.³ Of course, many British and foreign banks did not need to rely on explicit state support for their survival. As such, this heterogeneity means that our data set is ideally suited to testing for financial protectionism. We compare the loans of both British and foreign banks before and after nationalizations in a comprehensive data set that includes bank that were either public, private, or switched status from one to the other.

We use a standard panel data model with period- and bank-specific fixed effects to search for financial protectionism, taking into account period- and bank-specific shocks and characteristics. Our main focus is the fraction of domestic (British) loans a bank makes as a fraction of its total loan activity, a ratio we refer to as the “loan mix” and we also investigate interest rates. Our key finding is that after nationalisation, foreign banks reduced British as a share of total lending by about eleven percentage points, and increased interest rates on new loans to UK residents by 70 basis points. By way of comparison, nationalisation does not seem to affect either the lending or interest rate decisions of British banks. These results are robust to a variety of perturbations to the underlying empirical model. Succinctly, foreign nationalised banks seem to have engaged in financial protectionism, while British nationalised banks have not.

Understanding the causes and impact of financial protectionism is an interesting item for the research agenda, especially if our result is general.

³ Indeed, the first substantial public sector intervention during the crisis was undertaken in the UK with the nationalisation of Northern Rock in September 2007, the 5th largest mortgage lender at the time.