What Does the Future Hold for the International Banking System?

Mansoor Dailami and Jonathon Adams-Kane

The international banking industry faces a challenging future, having to consolidate at a time of heightened global financial volatility, anemic growth in advanced countries, and shifting global growth balances. After a long period of sustained expansion and accommodating regulatory treatment, the structure of international banking is changing as global banks’ business strategies shift toward fast-growing emerging-market economies. The center of gravity for international lending is shifting, with the role of European banks shrinking and American, Japanese, and emerging-market banks filling in the space. Against this backdrop, the current debate on adding economic stimulus to support the sputtering global economic recovery should consider the possible contractionary impacts of bank deleveraging, even with global interest rates remaining at historically low levels.

Making economic predictions is a tricky business in the best of times—and much more so in the current turbulent environment of weak global macro conditions and unsettled global financial markets. Yet, for the international banking industry, the key drivers shaping the future are already in motion: first, deleveraging, which remains a concern especially for euro area banks; second, international banks’ turn toward emerging markets as a central aspect of their long-term business strategy; and third, the reshuffling of international banks in terms of the nationality and sectoral composition of bank ownership—and in the long term, the rise of banks based in emerging markets.

Understanding how these trends are likely to unfold is key to assessing the extent to which the current global policy mix of fiscal tightening and unprecedented monetary easing in advanced countries will ultimately be effective in lifting the world economy out of this slow recovery phase and sluggish job creation. With international banking consolidation defining the medium-term backdrop, monetary easing by major central banks, even in the scale and form of recent unconventional asset purchase measures announced by the U.S. Federal Reserve and the European Central Bank (ECB), could be compromised by weaknesses in the monetary transmission mechanisms that will in turn bear on the supply of bank credit to the corporate and household sectors. The risk that bank deleveraging could reinforce prevailing fiscal contraction in several major economies supports the need for more concerted efforts to place the international banking system on a stable footing.

A Great Deleveraging Is Underway

For several decades running, the international banking industry steadily expanded. Driven to a large extent by institutions based in Europe, international lending by banks reporting to the Bank for International Settlements (BIS), a comprehensive measure of the international component of global credit, expanded more than fivefold as a percentage of global gross domestic product (GDP) between the mid-1970s and the mid-2000s. Over that time, international banks moved into the position of not only intermediating growing cross-border
capital flows, but also began playing a crucial role in domestic credit provision and financial sector development. But the long period of expansion in the international banking industry was brought to a dramatic halt as the financial crisis took hold, with lending falling from a peak of 64 percent of global GDP in early 2008 to 50 percent in 2009, and continuing to hover around the 50 percent level today.¹

For international banks based in all regions of the world, market and regulatory forces have generated pressure on them to deleverage their balance sheets. In principle, banks can reduce leverage either by increasing their capitalization or reducing their assets, the latter of which is achieved either by selling portions of their businesses or by scaling back on new lending. Regardless of the method though, through 2011, U.S. banks made greater progress in deleveraging than euro area or United Kingdom (UK) peers. One way to show this is to compare changes in banks’ loan-deposit ratios during the global financial crisis; comparing the 2009–11 average to the 2005–7 average, U.S. banks’ loan-deposit ratios declined significantly more than that of euro area and UK banks.² The average loan-deposit ratio of euro area banks did not decline significantly during this time, although those with the highest ratios leading up to the crisis did tend to show a decline. Going forward, European banks will have to deleverage much more than they have already; 24 of the largest European Union (EU) banks have publicly announced plans to deleverage by selling off an aggregate of roughly US$2 trillion in assets between 2011 and 2013 (IMF 2012).

The timing of the deleveraging cycle currently underway is poor in terms of its impact on near-term global economic conditions. Despite major central banks’ efforts to stimulate their economies, deleveraging among banks is reinforcing the contractionary economic environment already at work in the form of tight government budgets in major economies. Euro area countries find themselves in a particularly difficult position, for a variety of reasons.

In the decade leading up to the crisis, European banks transitioned away from reliance on retail deposits and toward borrowing in money markets to sustain a rapidly expanding asset base denominated in U.S. dollars.³ These funding channels proved to be much more interest rate, credit risk, and event sensitive than household deposits as the crisis took hold, leaving the most internationalized banks highly vulnerable when disruptions of the interbank liquidity market appeared, most prominently around the time of the collapse of Lehman Brothers in September 2008.

Beyond the differences in loan-to-deposit ratios among international banks across high-income regions, it is clear that European banks have been the most active in scaling back lending to borrowers in other countries. Foreign lending by euro area banks peaked at US$17 trillion in 2008, and has trended downward ever since, while postcrisis foreign lending by U.S., UK, and Japanese banks together has reverted more or less to its precrisis upward trend after a moderate dip in 2008 (figure 1).

### Figure 1. Foreign Claims by Bank Nationality, Global Total, June 1999–March 2012

<table>
<thead>
<tr>
<th>Year</th>
<th>Euro area banks</th>
<th>U.S., UK, and Japanese banks</th>
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<tbody>
<tr>
<td>1999</td>
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<td>2011</td>
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<tr>
<td>2012</td>
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</tbody>
</table>

Source: BIS Consolidated Banking Statistics.
Note: Foreign claims (the sum of local and cross-border claims) are measured on an immediate borrower basis, by nationality of reporting bank. For euro area banks, claims within the euro area but outside the home country of the bank are considered foreign.
covered a somewhat different sample of large banks, which were found to hold US$1.89 trillion of euro area sovereign debt as of end-September 2011, 192 percent of their tier 1 capital; again, the EU exercise found that banks’ exposures varied considerably.

Banks that are highly exposed to the sovereign debt of the crisis countries have cut back further on cross-border lending. Among the many efforts aimed at stemming the damage, one that impacted international banks based in the euro area most directly was the ECB’s three-year Long-Term Refinancing Operation (LTRO), disbursed in two tranches in December 2011 and February 2012. The plan encouraged euro area banks to take low-interest loans from the ECB to increase their sovereign debt holdings. Spanish banks, for example, increased their holdings of Spanish government debt from €182 billion at end-November 2011 to €236 billion at end-May 2012. Italian banks and money market funds stepped up their holdings of Italian government securities from €273 billion to €350 billion over the same period. The ECB may ultimately be bearing the bulk of sovereign risk, since banks typically put up sovereign and state-backed bonds as collateral on the LTRO loans. However, the spillover of sovereign to bank credit ratings suggests that sovereign exposure does have the potential to keep euro area banks’ borrowing costs relatively high, at least in the near term. Furthermore, the fact that a significant share of European banks’ assets will continue to be tied up in the region for the next few years will put up sovereign debt problems to banks’ access to capital markets, at least not enough to offset the effects of deleveraging.

One way to assess how well recent policy and regulatory initiatives have worked to stabilize the European banking system is to look for improvements in banks’ access to long-term private debt markets. Bond issuance by euro area banks in 2012 is still weak compared to that before the onset of the sovereign debt crisis, although issuance in July through September has shown some modest signs of recovery relative to the same period in 2011, taking into account the seasonality of bond issuance. This suggests that policy interventions have not managed to prevent the spillover of worsening sovereign debt problems to banks’ access to capital markets, at least not enough to offset the effects of deleveraging.

### Growth in Emerging Markets Vital to International Banks’ Rehabilitation and Long-Term Business Strategy

It is a testimony to how times have changed since the 1990s that having a foothold in the fast-growing emerging-market economies has become the mantra of long-term growth for major global banking institutions. Growing local firms and rising per capita incomes resulted in greater demand for international banking services in emerging and developing countries during the 1990s, and especially in the 2000s. Attracted by the opportunities for asset growth and risk diversification, international banks eagerly established branches and subsidiaries in developing countries and expanded their cross-border and local-lending portfolios to developing-country borrowers.

The growth of international banking activity in developing countries is reflected in the proportion of banking sector assets held by foreign banks. In developing countries, where the bulk of financial intermediation continues to occur through bank lending (rather than capital markets), foreign banks play a central role. As of end-2010, foreign-owned local banks controlled more than US$2.6 trillion in assets, about 11 percent of total banking assets in developing countries. Foreign bank presence is especially high in sub-Saharan Africa, where an average of 55 percent of the banking assets of a given country were held by foreign banks as of 2010, as well as in Eastern Europe and Central Asia (52 percent) and Latin America (41 percent; figure 2). In all developing regions, the share of banking assets held by foreign banks has increased since the mid-1990s, more than tripling in the regions of East Asia, Europe and Central Asia, and Latin America.

As of 2011, 24 international banks or bank holding companies operated subsidiaries in 20 or more developing countries. Citigroup leads the way in this regard, with a presence in 58 developing countries, while BNP Paribas, Deutsche Bank, Société Générale, and investment management firm Franklin Resources each operate in 33 developing countries (figure 3). For Citigroup, the strategy seems to have paid off; the firm generated approximately half of its consumer banking revenues in emerging markets during its 2011 fiscal year (CitiBank 2012).

International banks’ presence in developing countries could be helpful; there is evidence that the presence of foreign banks can positively impact efficiency and competition in developing countries’ banking sectors, as well as increase banking sector stability (Cull and Martinez-Peria 2010). But there are also potential serious downsides, as highlighted during the global financial crisis, when international banks served as a conduit for the transmission of financial shocks to developing countries. During that time, foreign claims of banks in high-income countries on developing countries were significantly impacted by interbank liquidity problems and by uncertainty of asset prices (Adams-Kane, Jia, and Lim 2012). The crisis also caused a contraction in lending by domestic banks in developing countries through global shocks to interbank credit markets (Cetorelli and Goldberg 2011).

Despite the negative impact of the global crisis on developing countries’ banking sectors, the pullback in lending by international banks to developing-country borrowers could have been much worse. Euro area banks, which held US$17.2 trillion in foreign banking claims at the peak of the market in 2008 (compared to US$8.4 trillion held by U.S., UK, and
Japanese banks combined) did not reduce their exposure to developing countries to anywhere near the extent that they did to the United States (figure 4). Thus, European banks are now in a position in which their loans to developing-country borrowers comprise a much larger share of their portfolios than do loans to borrowers in the United States.

The pullback by European banks in high-income markets is also evident in the data on cross-border mergers and acquisitions (M&As). Globally, European banks have only divested slightly on net via cross-border M&As, selling bank stakes in 286 deals for US$57.2 billion from 2008 through March 2012, while during the same period acquiring stakes in 227 deals for US$51.8 billion. At the same time, they have expanded moderately in emerging markets, taking on US$27.5 billion in bank stakes, while divesting US$14.3 billion. In other words, European banks’ small global net divestment via M&As has involved a net divestment in high-income markets that was less than fully offset by an expansion in emerging markets.

It remains an open question whether this differential pullback is driven mainly by current market conditions, that is, relatively robust demand for loans in developing countries, or by a strategy to concentrate in the markets with greater potential returns in the medium to long term. In either case, there will surely be some persistence in the result: that as European banks play a diminished global role, they will be more concentrated in developing countries than they were precrisis. Nevertheless, if European banks merely maintain their precrisis levels of claims on developing countries, this will mean that they will lose market share as deposits and loan demand in these markets continue to grow.

Figures 2 and 3. Share of Banking Assets Held by Foreign Banks, by Region, 1995–2010

<table>
<thead>
<tr>
<th>Year</th>
<th>East Asia and Pacific</th>
<th>Europe and Central Asia</th>
<th>Latin America and Caribbean</th>
<th>Middle East and North Africa</th>
<th>South Asia</th>
<th>Sub-Saharan Africa</th>
</tr>
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<tbody>
<tr>
<td>1995</td>
<td>40%</td>
<td>35%</td>
<td>25%</td>
<td>15%</td>
<td>20%</td>
<td>10%</td>
</tr>
<tr>
<td>2000</td>
<td>45%</td>
<td>30%</td>
<td>20%</td>
<td>10%</td>
<td>15%</td>
<td>5%</td>
</tr>
<tr>
<td>2007</td>
<td>50%</td>
<td>25%</td>
<td>15%</td>
<td>5%</td>
<td>10%</td>
<td>3%</td>
</tr>
<tr>
<td>2010</td>
<td>55%</td>
<td>20%</td>
<td>10%</td>
<td>3%</td>
<td>8%</td>
<td>2%</td>
</tr>
</tbody>
</table>

Sources: Bankscope database; authors’ calculations.
Note: Each regional percentage represents a simple average of the share of assets held by foreign banks in each region. Calculations are based on shareholder information available from Bankscope, individual banks’ Web sites, annual reports, banking regulation agencies’ publications and announcements, parent companies’ reports, and news articles. The dataset covers 4,496 commercial banks, saving banks, cooperative banks, and bank holding companies (all at legal entity level) in 131 developing countries. As of end-2011, 3,484 of these institutions were actively operating, and 3,403 have account information with Bankscope. Financial information for bank branches is not usually available, and in any case should be consolidated within the relevant parent company’s balance sheet. The dataset uses bank ownership information from Claessens, van Horen, Gurbani and Mercado (2006) for the period 1995–2005, which covers only two-thirds of the banks from developing countries due to the limited coverage of Bankscope database for some developing countries (including China and the Russian Federation) at the time. In addition to their 1,055 subsidiary banks, foreign banks hold stakes in 1,452 nonbank financial companies, 615 pension funds, 274 insurance companies, 12 venture capital firms, and 11 private equity firms in developing countries.
signs of erosion, with the fraction of loans (weighted by value) with participation by at least one euro area bank declining from a peak of nearly 93 percent in 2006, to less than 71 percent in both 2010 and 2011.

Historically, European banks have been a hugely important source of financing in developing countries. This is still the case, and will doubtlessly continue to be so for some time. But at the same time, European banks’ share of developing-country business can be expected to continue to gradually decline from the heights reached in the 2000s. A recent ECB (2012) report points out that non-EU countries, particularly those in Asia, may feel the pinch of deleveraging currently underway among euro area banks in the form of reduced availability of trade finance. At the same time, the pullback by European banks may signal an opportunity for banks in other high-income countries. Citigroup, for example, recently announced its intention to scale up its commodity trade finance operations on the heels of retreats in the business by BNP Paribas, Crédit Agricole, and Société Générale, among others (Braithwaite 2012).

Nonbank Financial Firms and Sovereign Wealth Funds Snap Up Stakes in Banks

As euro area banks shore up their balance sheets by selling off stakes in their businesses, especially subsidiary banks in high-income countries, it is notable not only that a large portion of these deals are intra-European, but perhaps more interestingly, that a large portion of buyers are nonbanks. In fact, nonbank purchases of stakes in banks have become more common on a worldwide level since the financial crisis. Globally, between 2008 and March 2012, banks divested US$132.6 billion worth of stakes in their subsidiary banks and bought US$97.5 billion in stakes, for a net divestiture of about US$35 billion. Nonbank buyers—namely, financial investment companies, private equity firms, and, sovereign wealth funds (SWFs)—acquired stakes of US$76 billion and divested US$40.8 billion (figure 5).

The largest of the six acquisitions by SWFs was the purchase of a 4.2 percent stake in Citigroup by the government of Singapore Investment Authority. SWFs from the Republic of Korea, Kuwait, and Qatar have also purchased stakes in banks based in advanced economies. Emerging-market SWFs have also shown strong interest in acquiring portions of banks in other emerging markets; Qatar Holding LLC’s acquisition of a 5 percent stake in Banco Santander Brasil was the most significant of these deals.

Though U.S. and emerging-market nonbank firms have been significant purchasers of bank stakes divested by European sellers, the two groups have shown interest in different target banks.12 U.S. firms acquired US$15 billion in stakes from European sellers between 2008 and March 2012, with nearly all of these deals (US$14.7 billion) for banks located in Europe. Emerging-market buyers, on the other hand, have acquired stakes in banks located in both emerging markets (US$5.2 billion) and in Europe (US$8.9 billion) from European sellers.13 Worldwide, emerging-market firms acquired US$40.6 billion in bank stakes via cross-border M&As, US$3.9 billion more than they sold. A little more than half (US$21.8 billion) of emerging-market firms’ bank acquisitions were in advanced economies.

Emerging-Market-Owned Banks Gradually Becoming Global Players

Recent shocks to credit provision in developing countries may be largely transitory, but they have had the long-term effect of

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**Figure 4. Claims of Euro Area Banks on Developing Countries and on the United States, June 1999–March 2012**

Source: BIS Consolidated Banking Statistics; authors’ calculations.
Note: International loans are measured by foreign claims on an immediate borrower basis, on individual countries by nationality of reporting bank, from the BIS. The developing-country total is calculated by summing across all developing countries.

**Figure 5. Banks’ Sales of Stakes in Subsidiary Banks, by Sector of Acquirer, January 2008–March 2012**

Sources: Authors’ estimates based on Thomson-Reuters SDC Platinum database.
hastening a gradual decline in developing countries’ dependence on high-income countries’ banks. Because developing countries represent a growing portion of the global economy, south–south foreign direct investment (FDI) has risen as well (Dailami, Kurlat, and Lim 2012), creating demand for international banking services between emerging-market economies. Figure 6 shows that the M&A component of south–south FDI has risen dramatically since about 2003. It can be expected that as demand for financial services to facilitate south–south FDI and trade continues to expand, southern banks will represent a growing segment of the global international banking industry.

The fact that domestic financial markets in the developing world are becoming increasingly sophisticated in terms of structure and scale, and that some of the largest banks in the world now reside in developing countries, supports the idea that developing-country banks are primed for ascendance within the international banking industry. Historically, developing-country banks have played a peripheral role on the global stage, to the extent that they are barely covered in the main quantitative measures of trends in the industry. Of the 25 banks that set the LIBOR (London Interbank Offered Rate), not a single bank is based in a developing country. Developing country banks’ costs of borrowing are similarly underrepresented in the Fed Funds, Eonia (Euro Overnight Index Average), and Euribor (Euro Interbank Offered Rate), because their limited participation in these interbank markets is dwarfed by that of the large, high-income country banks. Only eight developing countries report bank data to the BIS.

While developing-country banks are in many respects not yet a powerhouse on the global level, they already have a significant presence at the regional level. In sub-Saharan Africa, 55 percent of the foreign banks operating in countries in the region as of 2010 were based in other countries in sub-Saharan Africa, up from 44 percent in 2005, and another 10 percent were based in developing countries in other regions. In developing East Asian countries, 20 percent of foreign banks are based in other developing countries; the comparative figures in Europe and Central Asia and Latin America are 25 percent and 30 percent, respectively.

The growing presence of developing-country-based banks in other developing countries has several potentially important implications for international liquidity and credit provision (and hence investment), especially in the poorest countries. On one hand, it remains unclear whether capital flows from developing-country banks will prove to be stable sources of investment financing, given that international banks based in emerging economies may be more sensitive to domestic economic needs, such as buffering idiosyncratic shocks and meeting policy directives; this question has been a subject of debate, especially in regards to Chinese investment in sub-Saharan Africa. On the other hand, greater diversity of foreign financing sources may insulate developing countries’ banking systems from shocks originating in high-income countries, facilitate regional trade and FDI, and serve as a catalyst for regulatory coordination between countries at similar levels of institutional and financial market development. A rise in south–south cross-border banking signals not only a decoupling from European and other high-income country financial markets, but a maturation of domestic and regional financial markets. Over the long term, both south–south and south–north bank lending can be expected to increase, and will make up a significantly greater share of global cross-border lending than today.

Figure 6. Total Cross-Border M&A Deals between Firms from Emerging-Market Economies, 1997–2010

Source: Calculations by Dailami, Kurlat, and Lim (2012) from Thomson-Reuters SDC Platinum data.
A Word of Caution

As the international community goes through a process of soul searching and introspection in an effort to understand the causes and consequences of the 2008 global financial crisis, in which international banks were at the epicenter, looking ahead to anticipate the configuration of the international banking system would help not only to formulate regulatory reforms to strengthen the banking sector itself, but also to inform the current debate on international macroeconomic policy. The forward-looking analysis elaborated in this note contains a policy warning regarding the current mix of fiscal and monetary policy stances in the context of ongoing deleveraging by banks. By now there is a fair degree of consensus that progress in fiscal consolidation in advanced economies is likely to be slow, painful, and charged with political tensions. At the same time, there is a limit to how much monetary policy can be relied upon to simultaneously provide macroeconomic stimulus and address the specific needs of sovereign and banking finance, especially given the unprecedented ways in which central banks have intervened to stabilize financial markets (figure 7). The important implication that emerges from the current policy configuration and public debt profiles is that the banking sector may bear a significant part of the burden of heightened sovereign debt distress. For euro area banks affected by sovereign debt distress, the most visible signs, so far, have been deteriorating funding market conditions, significant credit rating downgrades, and a decline in market capitalization. Indeed, given the significant international presence of European banks and their deep role in global interbank markets, the potential for spillover of the negative feedback loop among public finances, the financial sector, and the real economy currently underway in the euro area should be of concern to the broader international policy community.

Acknowledgment

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About the Authors

Mansoor Dailami is the lead author of Global Development Horizons and Manager of the Emerging Global Trends Team, part of the Development Economics Prospects Group (DECPG) at the World Bank. Jonathon Adams-Kane is a contributing author of Global Development Horizons and a consultant economist with the Emerging Global Trends Team. This note builds on an Economic Premise note from March 2012, “Looking Beyond the Euro Area Sovereign Debt Crisis” (Dailami 2012). It uses a bank-level database, built by the Emerging Global Trends Team, that contains the nationalities of ownership of over 4,400 banks in developing countries, and is part of a larger ongoing study on international banking, with funding from the World Bank’s Knowledge for Change Program (KCP).

Notes

1. Authors’ calculations based on data from the BIS’ Consolidated Banking Statistics (http://www.bis.org/statistics/consstats.htm) and the World Bank’s Global Economic Monitor (various issues).

Figure 7. Shifts in the Global Macroeconomic Policy Mix, 2006-11

Sources: National sources, Bloomberg, Thomson Reuters Datastream, and IMF World Economic Outlook database.
Notes: Unweighted averages are shown. Advanced country averages are based on the euro area, the United States, Japan, the United Kingdom, and Canada. Developing-country averages are based on Brazil, China, India, Indonesia, Mexico, Russia, and South Africa.
2. Authors’ calculations based on Bankscope data.
3. Euro area and Swiss banks’ holdings of dollar-denominated assets expanded from less than US$2 trillion in 1999 to more than US$6 trillion in 2007 and 2008 (Baba, McCauley, and Ramaswamy 2009).
5. Another major plan to reduce fragility and uncertainty surrounding the banking sector is the formation of a banking union, shifting bank supervision to the European level. Also, in September 2012 it was announced that the ECB would buy the debt of struggling sovereigns via outright monetary transactions.
6. Totals were estimated from Bank of Spain data, for marketable forms of central government debt only, by summing the stripped government bonds and unstripped marketable government debt held by resident credit institutions.
7. Data are from the Bank of Italy, given as holdings of general government debt securities by monetary and financial institutions, excluding holdings by the Bank of Italy.
8. For some banks, increased capital adequacy requirements may have also played a role in spurring deleveraging in 2011 and the first half of 2012. A new European Banking Authority rule required large banks to meet a tier 1 capital to risk-weighted assets ratio of 9 percent by the end of June 2012.
9. However, this total asset share understates the substantial presence that foreign banks have in many developing countries, since a handful of domestic banks (mainly in China) are large enough to have a significant impact on global aggregate statistics. On a regional basis, too, some large countries with substantial domestic bank ownership swap aggregate measures, for example domestic Russian and Indian banks dominate absolute measures of foreign banks’ asset shares in their respective regions.
10. These are lower bound estimates, based on available bank ownership data from Bankscope.
11. When euro area and U.S. banks’ foreign claims are examined separately, bank balance sheet problems are also found to have been a significant factor and to have been associated with a decrease in European bank lending, but an increase in U.S. bank lending. This pattern may be due to more aggressive government support of banks in the United States than in Europe during the crisis, but perhaps also because in the most acute phase of the crisis, global volatility was concentrated in U.S. asset prices in particular, so that for U.S. banks, the developing world was a safe haven relative to the home market.
12. The definition of emerging-market economies used here follows Dailami, Kurlat, and Lim (2012), and where a complete list is provided. This definition is based on investment banks’ traditional classification of countries as emerging markets that are distinct from the historically advanced economies of North America, Western Europe, Japan, and Oceania.
13. The majority of euro area sellers’ stakes in emerging-market banks, however, have gone to buyers in the euro area.

References