Commodity price shocks hurt credit growth in developing countries

Big swings in global commodity prices unnerve governments in developing countries reliant on such export revenue, and curb credit growth as banks tighten lending during price volatility.

A look at 1,600 banks from 78 developing countries between 2004 and 2015, a period of large swings in commodity prices, found lenders become more cautious when prices fluctuate because clients may not be able to service loans, eroding the quality of bank assets and capital.

Banks with relatively lower deposits and poor asset quality are particularly vulnerable to commodity shocks and tend to be more aggressive in responding to price movements.

Similarly, banks that are more sensitive to fluctuations in commodity prices, and see a decline in deposit funding and an increase in bad loans in response to a fall in commodity prices, reduce credit supply when asset quality falls.

The data shows that a bank with high exposure to commodities and low deposits curbs lending by as much as 4.1 percentage points when commodity prices fall below expected trends, more if the fall deepens.

A decline in net export prices, such as was experienced by Nigeria from 2009 to 2010, led to a 4.9 percentage point contraction in lending by banks highly exposed to the commodity sector.

There is no significant difference in the lending behavior of foreign and domestic banks when commodity prices are volatile, particularly in low-income countries.

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But foreign banking entities have to rely on resources in the countries where they operate, and may not readily be able to source funds from the home bank in the event of a commodity price bust.

Still, an increase in commodity prices does not necessarily lead to a rise in credit supply.

A commodity boom may not affect bank lending as greater profits of commodity exporters and government may end up being spent on more consumption rather than increasing the deposit base of the banking system via more savings.

What developing countries need are strong financial regulations and policies that reduce risk to the financial system and strengthen the resilience of banking systems to commodity price shocks.

This episode is based on research done for ADBI by Isha Agarwal, a PhD student at Cornell University, in the United States; Rupa Duttagupta, chief of the Emerging Markets Division, International Monetary Fund; and Andrea F. Presbitero, an economist at the IMF and assistant professor in economics at the Università Politecnica delle Marche, Ancona, Italy.

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