

Foreign Debt Flows and Domestic Credit: A Principal-Agent Approach

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The relationship between capital flows and domestic credit emerges from different channels which are usually not directly identified. In this paper, a principal-agent approach is proposed in order to disentangle the channels through which shocks on capital debt flows can affect credit-related variables. The model predicts that a foreign credit crunch will affect aggregate credit and will reduce the proportion of firms with access to intermediated funds. A VEC model is estimated to empirically validate the predictions from the theoretical framework. In the short-run, a negative shock to foreign funds effectively reduces the proportion of firms with access to intermediated finance, whilst at the same time induces a substitution of funding by firms from foreign to local sources, thus effectively having a positive effect on domestic credit growth. Nonetheless, the estimated long-run relationship indicates that capital flows and credit are positively related. These results have important policy implications, related with the potential impact on credit (and access) generated by the use of certain macroprudential measures.