the headquarters' country to conserve capital or liquidity) could lead to a slowdown in growth in the host country, which in turn could affect the decisions of others foreign lenders. The host economy might find funding abruptly curtailed. Agreements among banks, such as the Vienna Initiative brokered by the EBRD, sought to slow the pace of credit contraction, but the vulnerability of Central and Eastern European economies in the absence of such coordination was clear.

By contrast, Latin America, a region that has traditionally been severely affected by international financial turbulence, was relatively resilient during the global financial crisis. High levels of indebtedness, weak banks and currency mismatches had been amplifying factors in previous episodes of global financial turbulence, but this time was different.

Macroeconomic policies—in particular fiscal conservatism, monetary policy geared to a price stability objective, high degrees of exchange rate flexibility, and sound prudential regulation of the banking system—all help to explain Latin America's resilience. However, the model of integration with foreign banks certainly played a role, especially when compared to emerging Europe. Foreign banks that want to do retail business and take deposits in the great majority of cases incorporate in the host country as a subsidiary, that is, a standalone bank rather than as an office. This creates a structure of corporate governance that is more consistent with local financial stability than one in which the affiliate is a branch that follows instructions and policies dictated by the parent bank.[19]

An important component of the regulation of foreign affiliates is a strict limit on deposits that the affiliate can make in the parent bank, so the risk of using the local bank to fund the parent bank is limited. There may be some ways to circumvent the regulation, but when the bank is a subsidiary the responsibility is on the local management and the local board. In this organizational structure, the host country imports the foreign bank's management expertise, brand, and technology without necessarily suffering from financial contagion in the case of a crisis in the parent bank's economy.

To be sure, requiring subsidiaries to rely on local funding and to ring fence their capital has some costs—it segments financial markets and hampers international movements of capital at times when they might be beneficial. To the extent that cross-border capital flows are not impeded but instead are pushed into safer channels, however, the stability-enhancing benefits of requiring locally funded subsidiaries may dominate.

Local funding did not prevent a reduction in domestic credit in Latin America after the Lehman collapse, but that reduction was not necessarily triggered by procyclical behavior of foreign banks. Indeed, the 2009 recession was accompanied by a sharp reduction in domestic credit. This was due, however, not just to tighter financial conditions on the side of lenders but also to the decline in demand for credit. In any case, credit recovered once economic conditions improved. See Appendix A for a detailed examination of the Latin American case.

Valuation Effects, Dollar Funding, and Flight to Safety

We have seen the importance of not just net capital inflows and the current account but also gross inflows and outflows and their composition. The stock counterparts of gross outflows and inflows are foreign assets and liabilities, respectively. The values of these stock positions and, hence, a

[19] Many countries adopt the same regulation for branches and subsidiaries. The most relevant difference is that branches do not have a local board, while subsidiaries do. With branches, the foreign bank is responsible for any problem in its foreign office. Subsidiaries limit contagion across affiliates. In addition, subsidiaries can have local or other partners. These are strong incentives for banks to use the subsidiary model to expand across regions, when regulation is mostly the same for all foreign affiliates.