The contribution of trade in financial services to economic growth and development

Thorsten Beck
Finance – why do we care?
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Financial intermediation and growth

- Finance is pro-growth and pro-poor
- Provides payment infrastructure for real economy
- Intermediates savings from savers to private and public sector
- Allocation function is critical!
  - Impact through productivity growth and reallocation of capital more important than through capital accumulation
  - More firm entry and firm growth to optimal size
  - More innovation and better capture of growth opportunities
  - Positive impact through governance
- Pro-poor effects through indirect channels, including labor market, migration etc.
The dark side of finance

- Fragility is at core of intermediation function
- Risks both on funding (bank run, market freeze) and asset side (agency problems)
- Opacity of banks’ balance sheets
- Free-rider problem undermines market discipline
- Externalities of bank failure for rest of financial system and real economy
  - Domino, hostage, fridge problems
- Externalities of bank failure lead to establishment of (implicit or explicit) financial safety net (subsidy)
Figure 5. Bank Failures and Interventions in Selected Countries

Failures and interventions as a % of total banking assets over the period August 2007 to August 2011.

Source: Laeven and Valencia
What role for financial globalization?

- Different modes
  - Cross-border equity investment (direct, portfolio etc.)
  - Cross-border lending (to banks, to customers)
  - Foreign direct investment by financial institutions
  - Public vs. private
- Focus on foreign bank entry
- To which extent can foreign banks contribute to financial deepening and economic growth/poverty reduction through the channels outlined above?
- To which extent can cross-border banking undermine stability?
Increase in flows over time

Source: Claessens and van Horen (2012)
Merger activity

Source: Buch and de Long (2010)
What drives foreign bank entry?

- Follow the client: especially valid in developed countries; positive correlation between foreign bank entry and non-financial FDI
- Market opportunities: especially valid in developing countries
  - Higher growth opportunities
  - Larger economies (scale)
  - Fewer regulatory restrictions
  - Colonial, historic, geographic and linguistic ties and commonalities
  - Crises
Domestic vs. foreign banks – the effects

- Foreign banks can bring
  - New resources (especially after crisis)
  - Bring more competition (but not always)
  - Help upgrade technology and regulatory standards
  - Thus ultimately help deepen financial systems

- …but can also
  - Increase volatility
  - Cherry pick clients and crowd out banks that serve low-end clients
But what about reality?

- Stability, mostly positive (more below)
- Efficiency – mostly positive, unless in non-competitive environment
  - Benefits contingent on contractual and information framework in economy, competition etc.
- Access – ambiguous results
- Regional variation
  - Central/Eastern Europe – overall positive effect, helped build up financial market, served as macroeconomic disciplining tool
  - Latin America – mixed – consider Mexico
  - Africa – hampered by other constraints
- Critical differences according to size of subsidiary/branch
- Cross-border banking is changing face
Source: Mian (2006); data on Pakistan
Domestic vs. foreign banks – different lending technologies

Cross-border banking is changing face

Source: Claessens et al. (2010).
Central and Eastern Europe

- Cross-border banks key in transition process towards market-based financial system
  - Macroeconomic stability
  - Cutting entrenched relationships to incumbent firms
  - Overall positive experience with foreign banks
- Rapid financial deepening
  - Household credit
  - Foreign currency on both sides of balance sheet
- Macroeconomic imbalances by 2007
Desirable Cross-Border Banking

- A “healthy” amount of cross-border banking is likely to be beneficial
  - Diversification benefits for domestic banks
  - Diversification benefits for domestic borrowers
  - But: higher volatility of flows
  - But: contagion costs
- Differential effect of home and host country shocks
Measuring the balance of cross-border banking: inflows

High inflows: $\ln > 0.4$ (NMS)
- Baltics very lumpy diversification (Scandinavia)
- Also, Finland low inward diversification (0.3)
Measuring the balance of cross-border banking: outflows

High outflows: $\text{Out} > 0.2$
- Sweden very lumpy diversification (Nordic Baltic)
- Austria low diversification (NMS)
Overall integration in Europe

- The Good : Netherlands, UK, Germany
- The Bad : NMS, Austria and Greece
- The Ugly : Baltics & Nordics

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Policy implications

- Major centers (London, Frankfurt and Paris) well diversified
- Dependence of new member states on Western banks
  - Change structure (diversify inflows, get outflows)
  - Ringfencing by subs (are firewalls working?)
  - Sharing of the financial stability risks (Joint Vienna)
- Nordic Baltic region
  - very connected -> strong contagion
  - Nordic Baltic MoU: burden sharing
The trilemma of cross-border banking

1. Global financial stability
2. Cross-border banks
3. National authorities

- Trend towards cross-border consolidation increases similarities and interconnectedness, increasing systemic risk
- Additional external costs arising from cross-border bank failures
- Different legal systems and limited information exchange
Cross-border bank resolution in 2008 – what went wrong?

- During 2008 crisis: asymmetry between monetary policy and regulatory authorities
  - Better prepared? Biased incentives!
- No cross-border bank resolution framework
  - Banks global in life, national in death
  - MoUs and colleges of supervisors did not work
  - Why? Incentives!
  - Beck, Todorov and Wagner (2012): stronger incentives to intervene if high foreign share of equity, weaker incentives if high foreign share in assets and deposits
Biased supervisory incentives to intervene in cross-border banks

CDS spreads of large (mostly cross-border) banks three days before intervention during 2008/9 crisis;
Source: Beck, Todorov and Wagner (2012)
Implications for regulation of cross-border banks

- **Needed:**
  - Resolution at the group level, as resolution at national level results in efficiencies (example: Fortis, 2008)
  - Clear lines of command, aligned with firing power

- **In Europe:**
  - ECB is operating as the de facto *lender of last resort* for European banking system.
  - EBA must get the cross-border banks under its *supervisory* wings
  - A European *resolution* authority should be established to resolve troubled cross-border banks, possibly combined with deposit insurance.

- **On global level:**
  - Ex ante burden-sharing rules and living wills as first step
Summary

• How to harness the best of financial globalization while minimizing risks?
• Competition, diversification, infrastructure as necessary conditions for reaping benefits of cross-border banking
• Sound and effective supervision and resolution framework on national level
• Better supra-national framework needed for regulation and resolution of cross-border banks