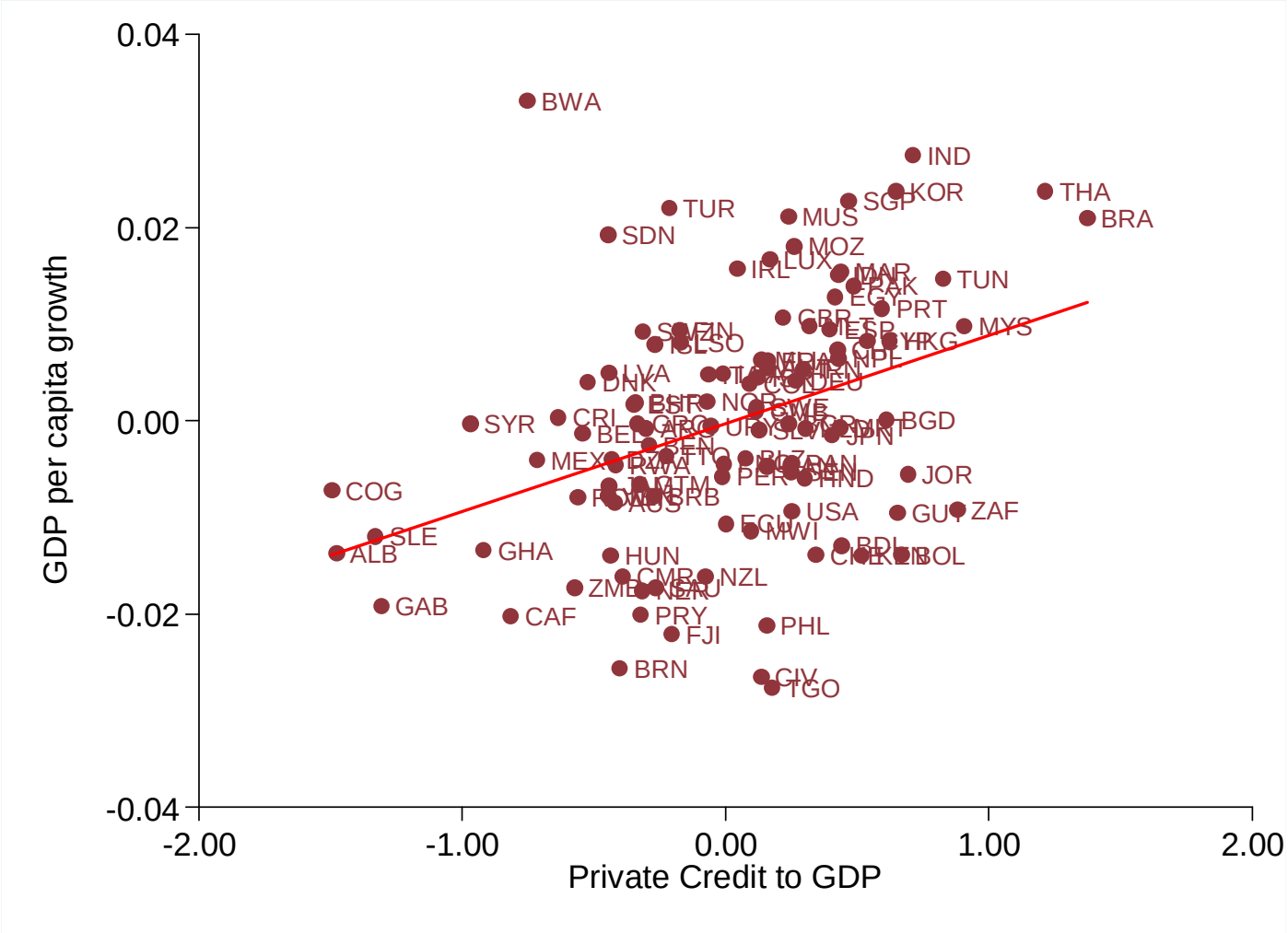
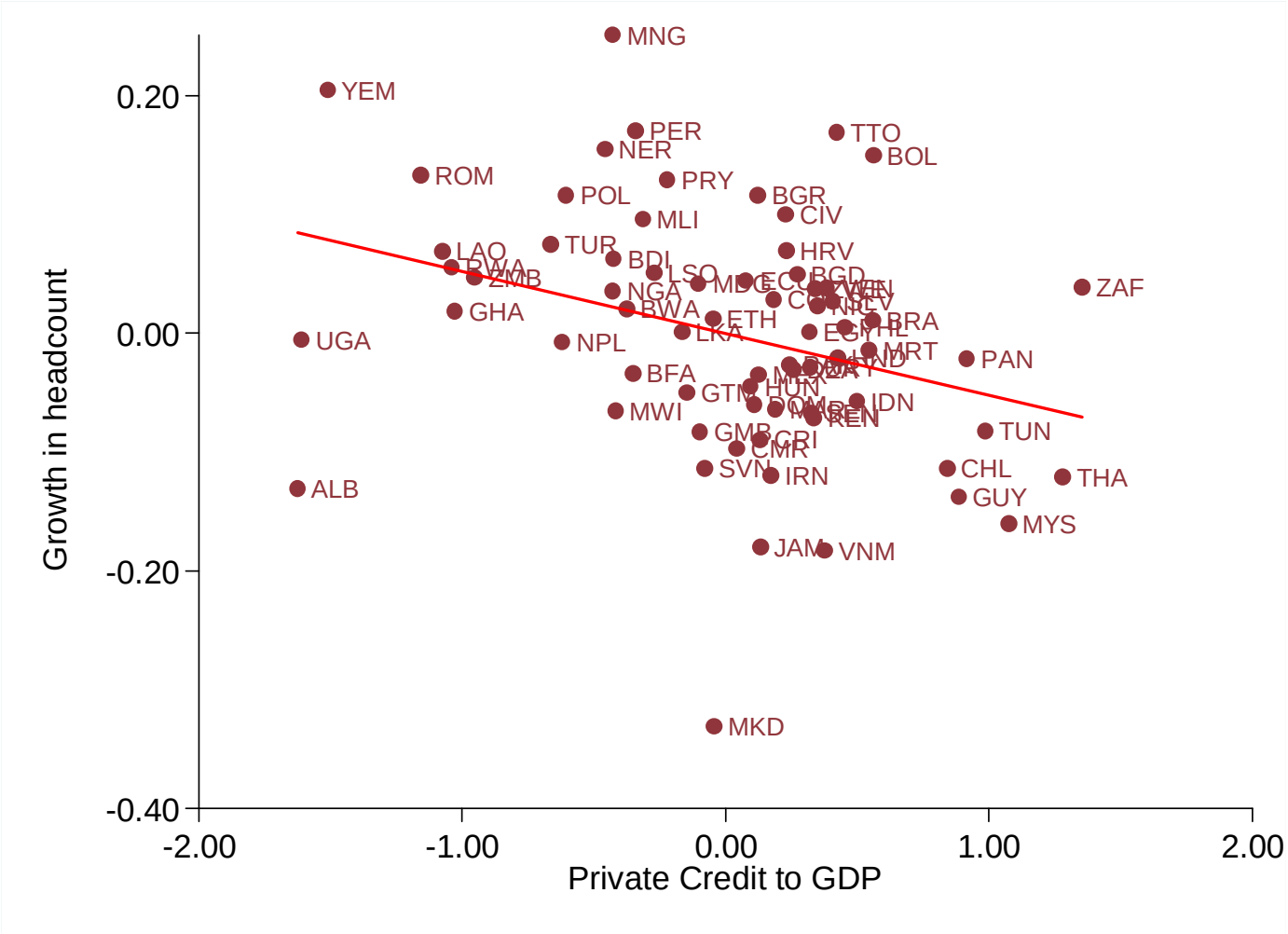
The contribution of trade in financial services to economic growth and development

Thorsten Beck

Finance – why do we care?



Finance – why do we care?



Financial intermediation and growth

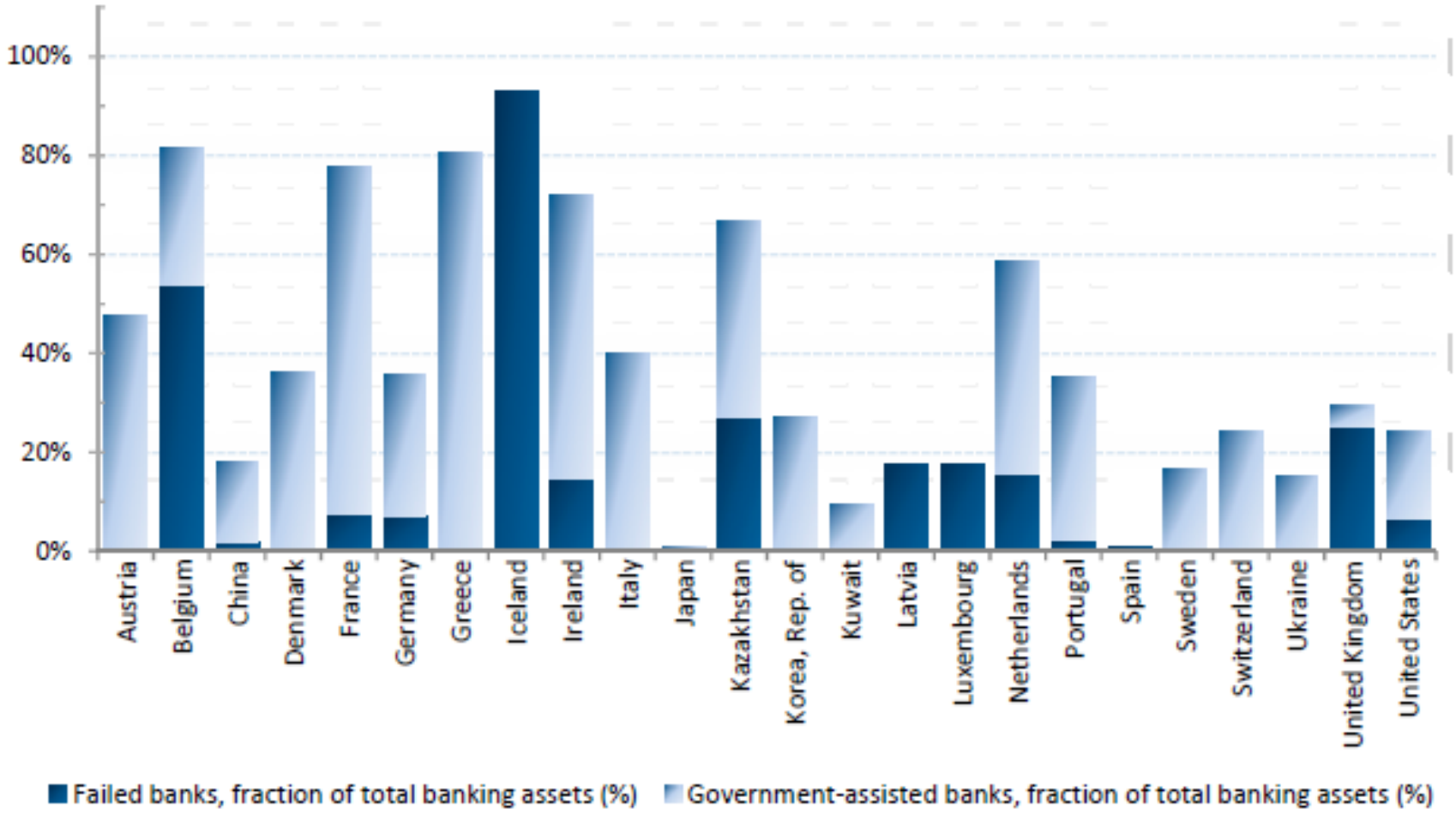
- Finance is pro-growth and pro-poor
- Provides payment infrastructure for real economy
- Intermediates savings from savers to private and public sector
- Allocation function is critical!
  - Impact through productivity growth and reallocation of capital more important than through capital accumulation
  - 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

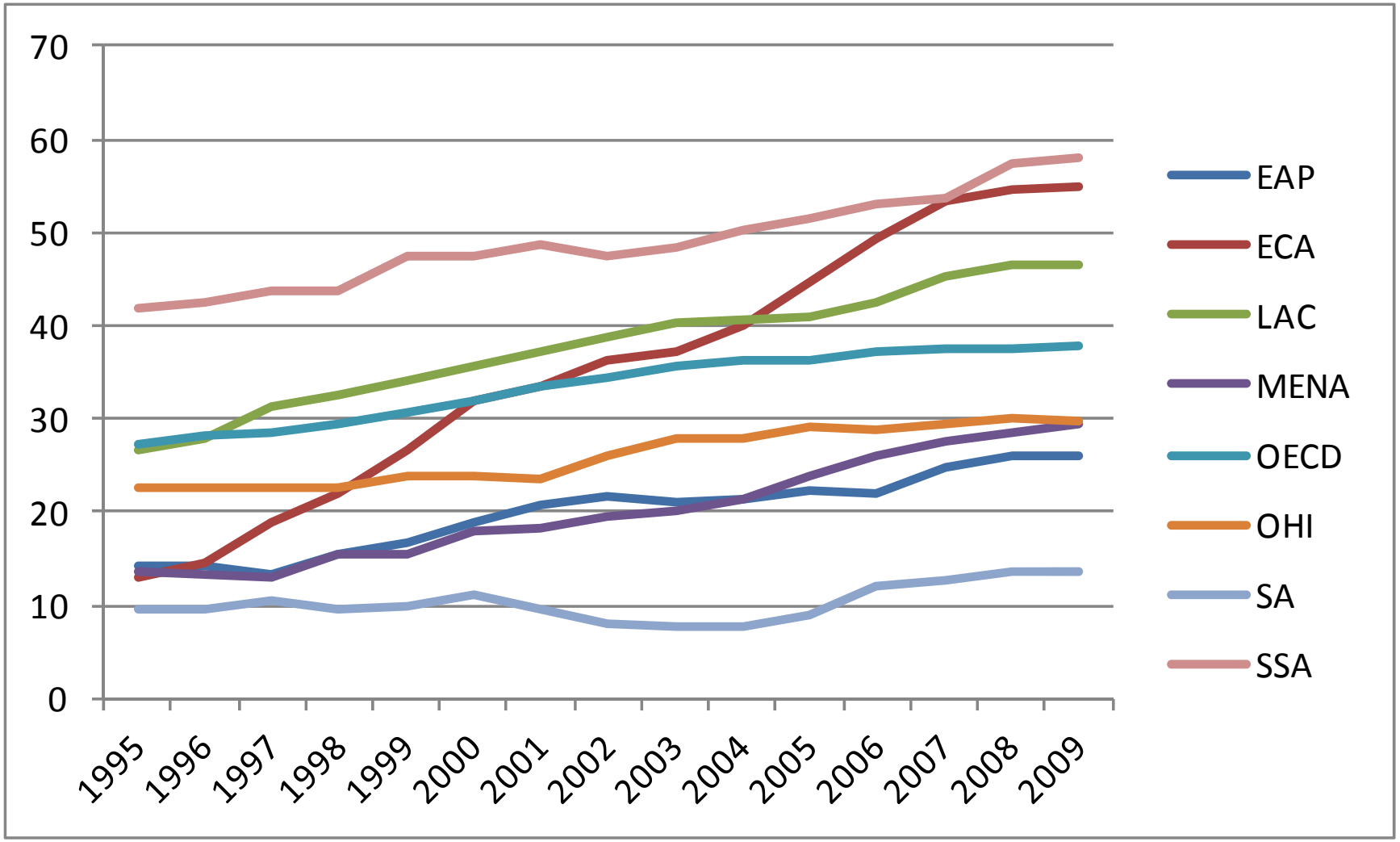


Source: Laeven and Valencia

What role for financial globalization?

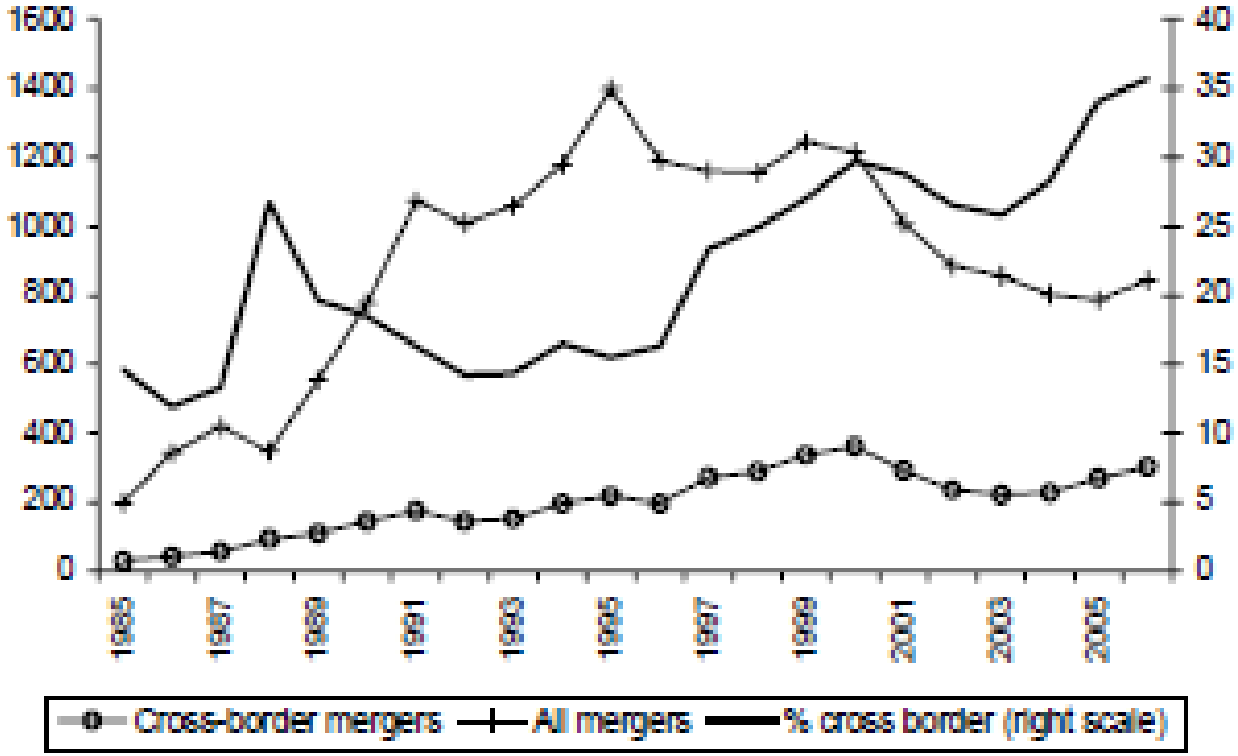
- Different modes
  - Cross-border equity investment (direct, portfolio etc.)
  - Cross-border lending (to banks, to customers)
  - Foreign direct investment by financial institutions
  - Public vs. private
- Focus on foreign bank entry
- To which extent can foreign banks contribute to financial deepening 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?

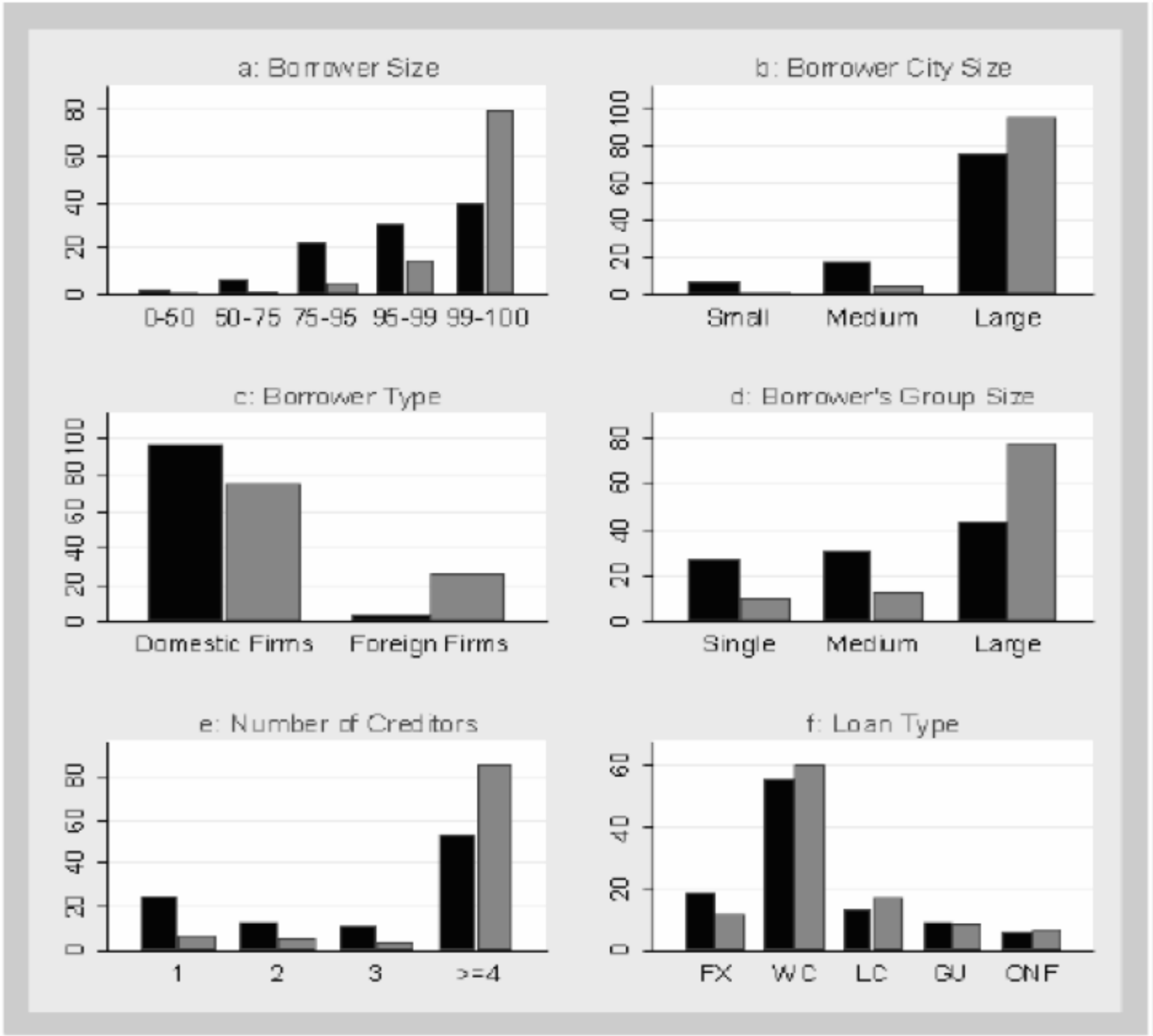
- Follow the client: especially valid in developed countries; positive correlation between foreign bank entry and non-financial FDI
- Market opportunities: especially valid in developing countries
  - Higher growth opportunities
  - Larger economies (scale)
  - Fewer regulatory restrictions
  - Colonial, 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?

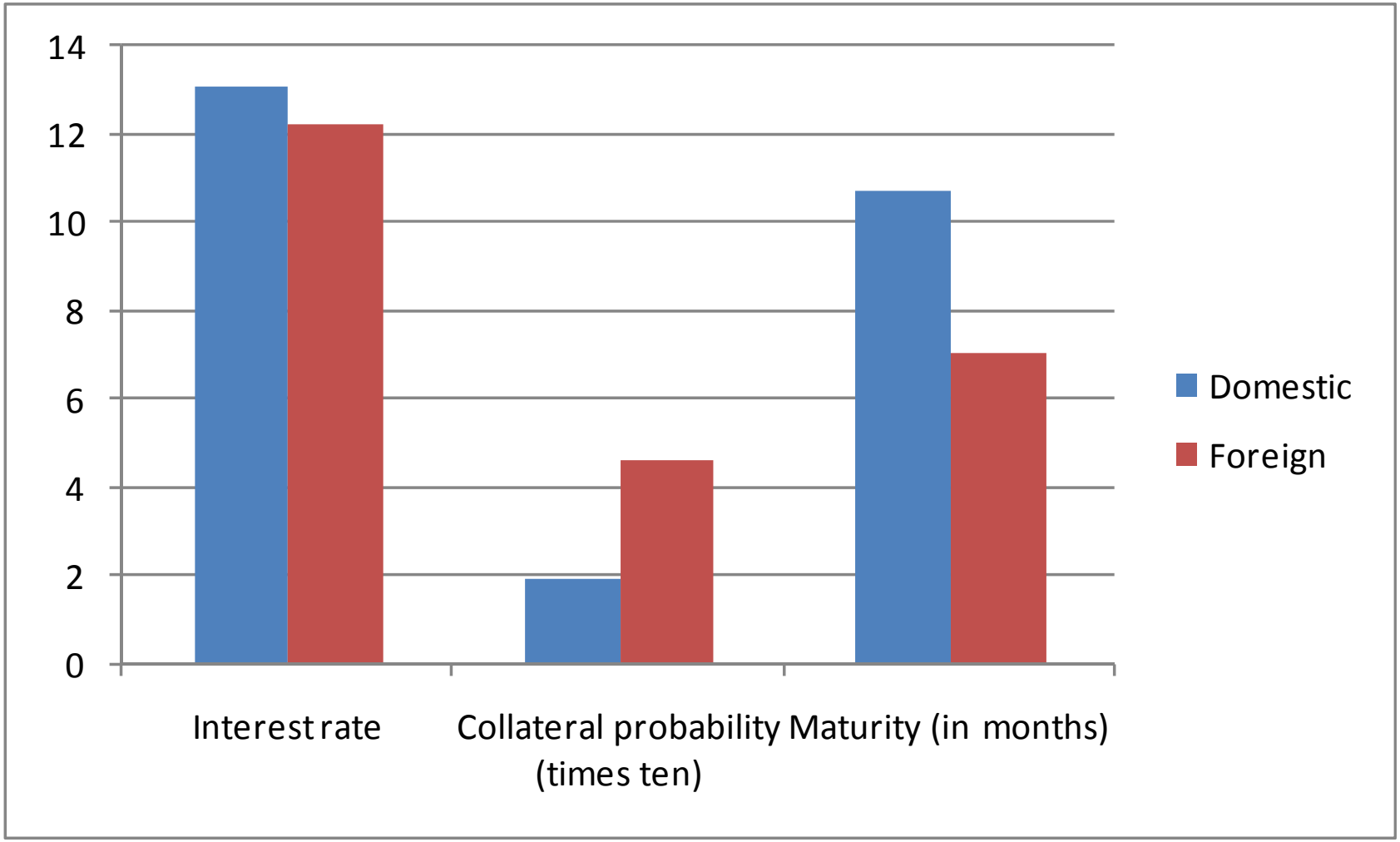
- Stability, mostly positive (more below)
- Efficiency – mostly positive, unless in non-competitive environment
  - Benefits contingent on contractual and information framework in economy, competition etc.
- Access – ambiguous results
- Regional variation
  - Central/Eastern Europe – overall positive 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



Domestic Foreign

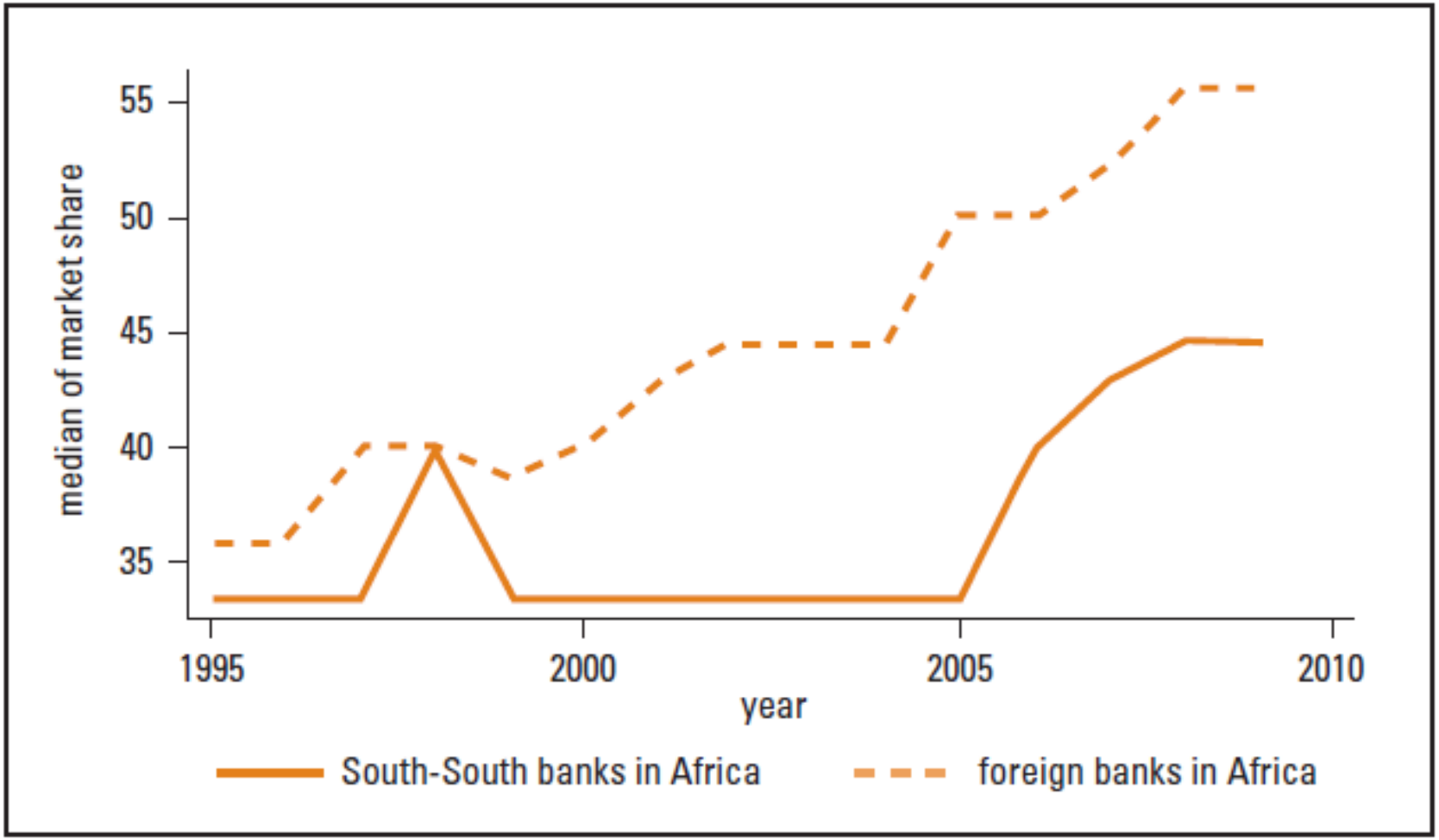
Source:Mian (2006); data on Pakistan

Domestic vs. foreign banks – different lending technologies



US dollar loans in Bolivia, 1998 to 2003, sample of clients that take loans from both domestic and foreign banks in same month. Source: Beck, Ioannidou and Schäfer (2012)

Cross-border banking is changing face



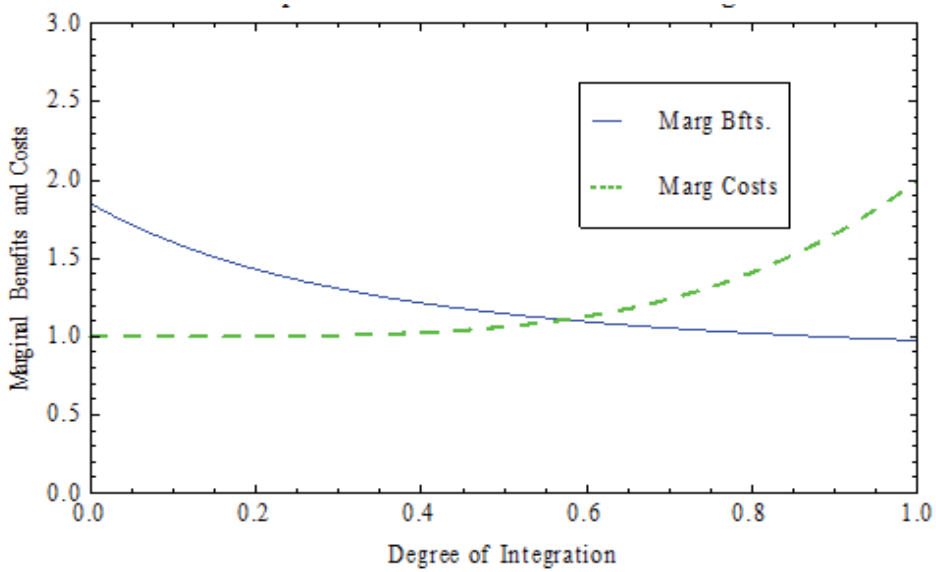
Source: Claessens et al. (2010).

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

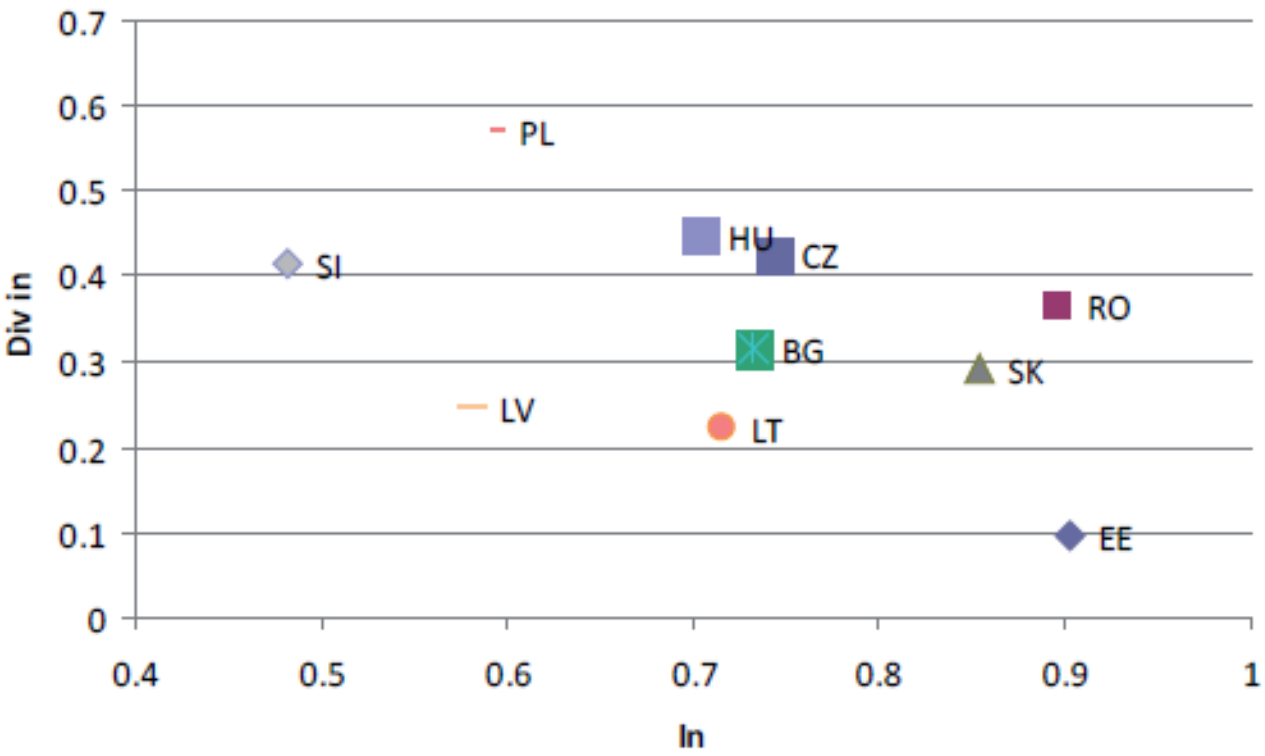
- A "healthy" amount of cross-border banking is likely to be beneficial
  - Diversification benefits for domestic banks
  - Diversification benefits for domestic borrowers
  - But: higher volatility of flows
  - But: contagion costs
- Differential effect of home and host country shocks



Measuring the balance of cross-border banking: inflows

High inflows: In > 0.4 (NMS)

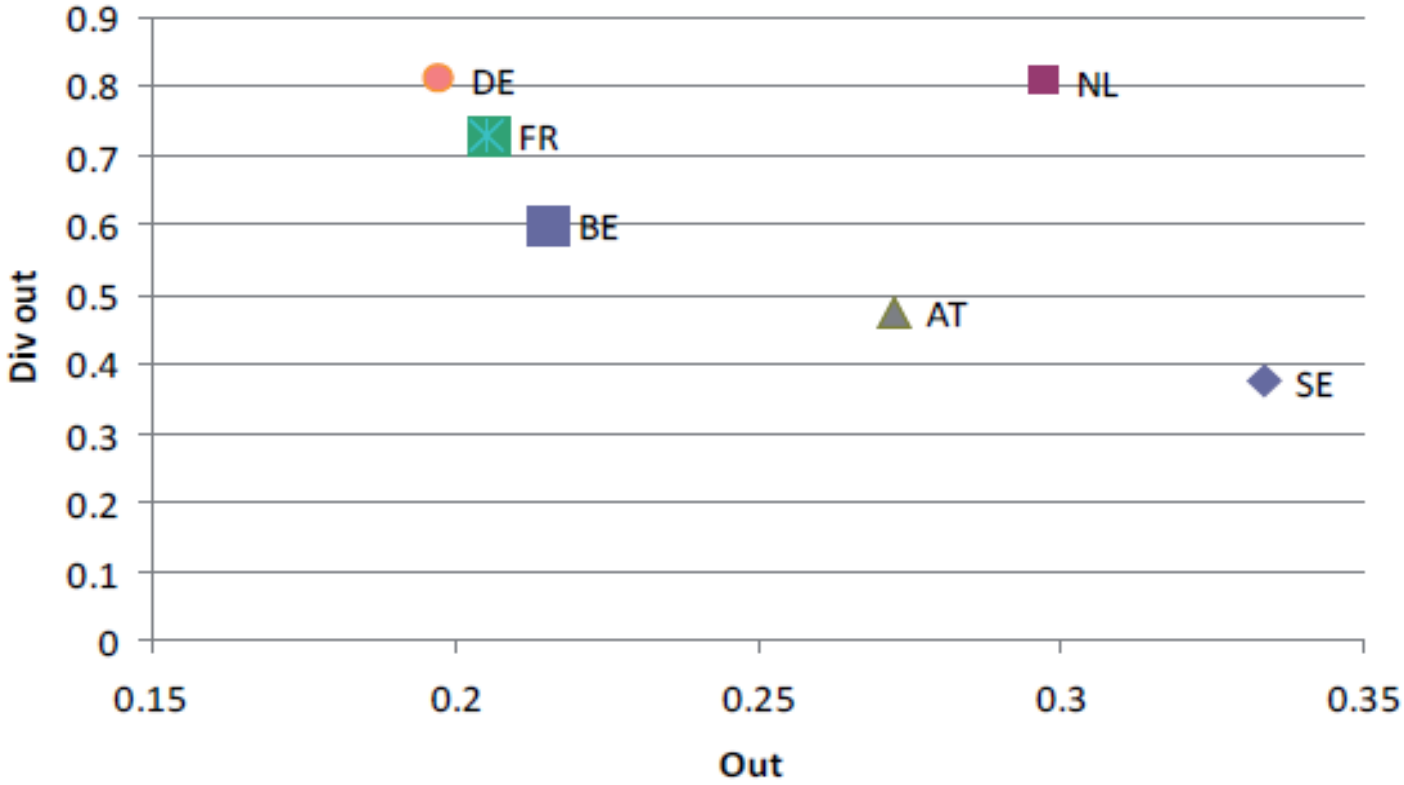
- Baltics very lumpy diversification (Scandinavia)
- Also, Finland low inward diversification (0.3)



Measuring the balance of cross-border banking: outflows

High outflows: Out > 0.2

- Sweden very lumpy diversification (Nordic Baltic)
- Austria low diversification (NMS)



Overall integration in Europe

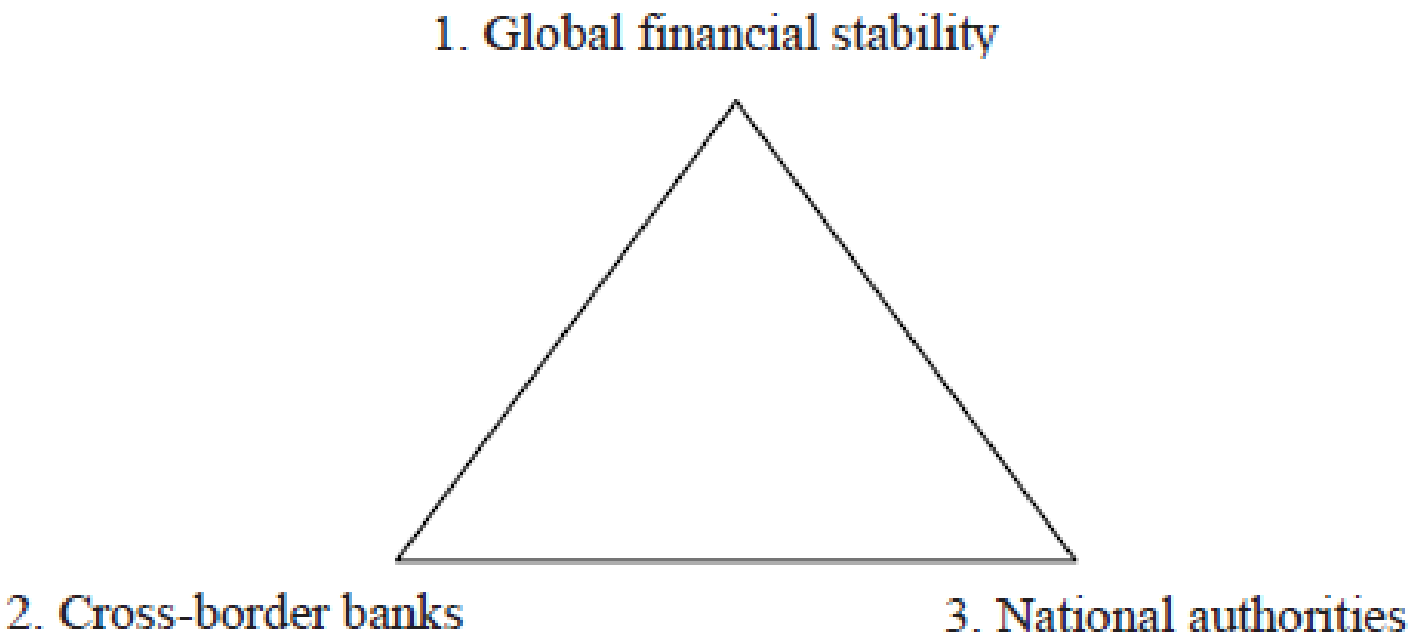
- The Good : Netherlands, UK, Germany
- The Bad : NMS, Austria and Greece
- The Ugly : Baltics & Nordics

Well balanced		Weakly balanced		Unbalanced		Very unbalanced	
Country	**Overall**	**Country**	**Overall**	**Country**	**Overall**	**Country**	**Overall**
Netherlands	0.78	Spain	0.74	Sweden	0.48	Hungary	0.22
United Kingdom	0.76	Ireland	0.71	Luxembourg	0.34	Czech Republic	0.21
Germany	0.75	Italy	0.69	Poland	0.29	Slovenia	0.21
		France	0.66	Cyprus	0.28	Romania	0.18
		Portugal	0.62	Malta	0.25	Bulgaria	0.16
		Belgium	0.62			Finland	0.15
		Denmark	0.61			Slovakia	0.15
		Austria	0.60			Latvia	0.12
		Greece	0.58			Lithuania	0.11
						Estonia	0.05

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

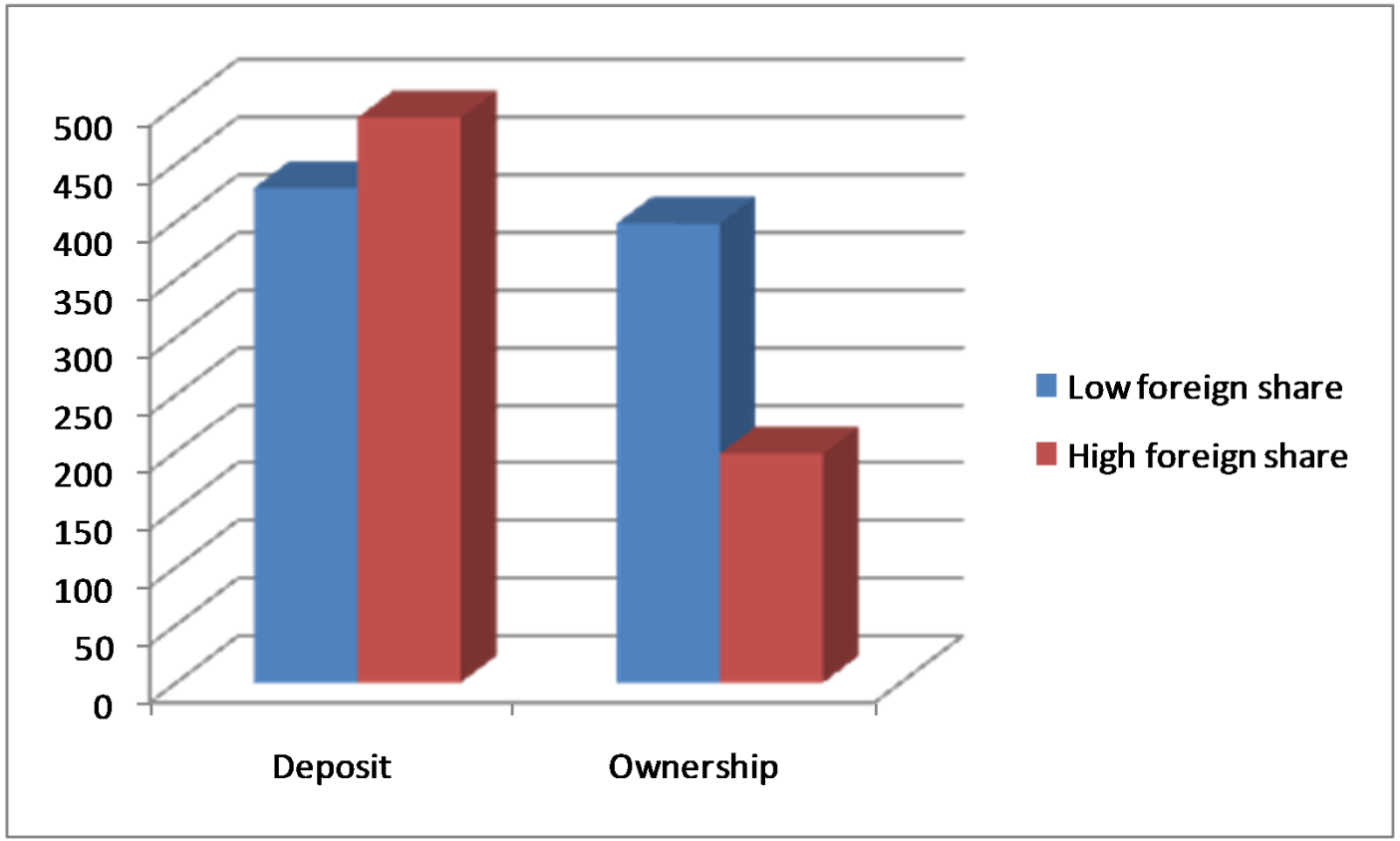


- Trend towards cross-border consolidation increases similarities and interconnectedness, increasing systemic risk
- Additional external costs arising from cross-border bank failures
- Different legal systems and limited information exchange

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