Foreign banks and financial stability in emerging markets: evidence from the global financial crisis

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Discussion by

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Summary

- Question:

  Does a higher share of foreign ownership of EME and DC banking sector assets stabilize cross-border capital flows and domestic credit in times of financial distress?

- Several empirical studies on banking have pointed out advantages of foreign banks presence especially in emerging markets (e.g. Ongena/Gianetti; de Haas; Demirguec-Kunt)
- Sample periods of these studies comprise domestic banking crises, but no crises in host countries of foreign banks
- Effect of foreign banks on stability of domestic banking markets during a global financial crisis is unknown

Merits

- Very important research question
- Current crises constitutes a very nice exogenous event for most emerging markets that can be used to explore the effects of foreign banks
- Especially Eastern Europe is a great laboratory (since foreign banks have a high market share)
- Interesting illustration of global (and regional) cross-border capital growth and credit growth

Comments

Motivation

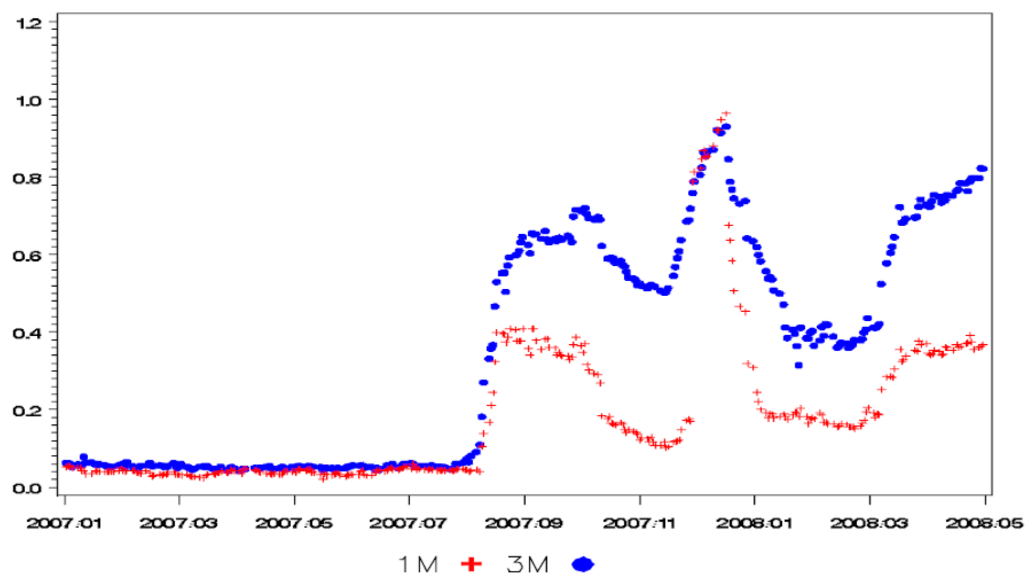
- What do foreign banks do to stabilize a financial system under distress?
  - Is this really a policy proposition? Based on which findings?
  - Why should foreign bank presence isolate domestic credit from international shocks? (e.g. Peek & Rosengren AER; Stiglitz)
  - Your motivation ignores the risks associated with foreign banking
- What is the expected relationship between capital flows and share of foreign banks?
  - Foreign investors can either invest in other countries by establishing banks or use capital flows – foreign share and capital flows should be substitutes

Comments

Identification

- Quote: “As the Lehman event marks a clear-cut beginning of the crisis,…”
- Define dependent variables as the difference (2008Q4-2009Q1)-(2007Q3-2008Q2)
- Your graph on credit growth shows significant drop in 2007!

Euro LIBOR-OIS Spreads



(taken from Schwarz, 2009)

Comments

Identification

FALL(i) = a FBAS(i) + b SURGE(i) + controls + epsilon

- Dependent variable is absolute (!) change in cross-border flows before/after Lehman collapse (kind of volatility measure)
- Dependent is change in growth rate before/after Lehman event
- Positive shocks should be zero at worst
- It is unclear what these dependent variables really measure – especially since the pre-event period was also a crises period
- Why not simply taking level or volatility of credit growth?

Comments

Results

Table 1: The basic model

Dependent variable: respective *FALL* measure

	Flows 1/			Credit 2/		
	(1)	(2)	(3)	(4)	(5)	(6)
FBAS	-0.0255**	-0.0299***	-0.0198**	-0.0019	-0.0054	-0.0055
	(0.0119)	(0.0096)	(0.0078)	(0.0050)	(0.0044)	(0.0045)
SURGE 3/ 4/		0.4070***	0.1678***		0.6872***	0.7052
		(0.0548)	(0.0555)		(0.1371)	(0.4565)
SURGE^2			0.0610***			-0.0050
			(0.0085)			(0.1206)
constant	5.6461***	3.7180***	1.2198**	0.5753**	-0.2296	-0.2392
	(0.5808)	(0.5313)	(0.5536)	(0.2520)	(0.2720)	(0.3594)
R-sqr	0.046	0.399	0.612	0.002	0.252	0.252
N	97	97	97	78	78	78

- Evidence of columns 1-3 consistent with substitution story
- Economic activity growth is insignificant

Comments

Results

- Causality (Omitted variable bias): Share of foreign banks is likely to proxy for many institutional variables, since foreign banks are not willing to work under uncertainty
- Quality of the financial system is likely to be related to stability
- Even the authors control for many of these institutional variables, the presented cross-country specification is difficult to rule out alternative stories
- Focus on within country variation

Suggestions

- Important research question – keep focus
- Combining emerging and developed economies
  - for developed economies shock was not clearly exogenous
  - Foreign banks role is likely to differ between foreign and domestic banks
- Use micro data on foreign banks’ lending and focus on one region