EUROPEAN CENTRAL BANK

EUROSYSTEM

Foreign Banks and Macroeconomic Fluctuations: Evidence from Financially Integrated Emerging Markets

Alistair Dieppe
European Central Bank

Discussion

ECB/Bank of Canada conference 8-9 June 2015

The views expressed do not necessarily reflect those of the ECB

Overview

1 **Summary of paper**

2 Some comments

Study association between macroeconomic volatility and foreign banks

- **Macroeconomic volatility depresses investment and hinders economic development**

- **Foreign banks have different exposure to external and domestic liquidity compare to domestic banks**

  - **may imply different real effects :**

    - **Normal times: Foreign banks buffer idiosyncratic shocks or country-specific shocks due to diversification and access to foreign funds**

    - **Large scale and highly correlated shock: Foreign banks lose ability to absorb extreme shocks**

Key Findings:

1. **Presence of foreign banks**
   - Overall no significant effect on growth volatilities
   - Higher levels of financial developments amplified output and consumption growth volatilities
   - Lower levels of financial development mitigated investment volatilities.

2. **During 2008/09 Global Financial Crisis (GFC)**
   - Foreign banks lose ability to absorb extreme shocks.
   - Depends on level of financial intermediary development

3. **Widespread variation (heterogenous) across regions**
   - Dampening volatility in Latin America
   - Magnified volatility in Asia
   - No effect in Emerging Europe (significantly affected by GFC).

Overview

1 Summary of the paper

2 **Some comments**

Foreign banks or global financing – what matters?

Exposure of (domestic) bank to abroad

- **financing abilities, both assets & liabilities**
- **foreign banks funded through domestic deposits → mitigate volatility**

Currency mismatch

- **local currency versus foreign currency funding & lending**
- **domestic borrowers unhedged → increase volatility**

Global financing

- **Share of stock market & bond market owned by foreigners**
- **Financing via cross-border corporations**
- **Non-bank private sector claims (FDI etc)**

Are residuals a good measure of macroeconomic volatility?

- Try **5-year moving** average?
- **Estimate with GMM** to address endogeneity?
- Very **few variables significant**
- **Missing financial variables** credit to GDP, interest rates etc
- **Too many dummies?**
- **Unexplained variance is high**

Table A.1. First Stage Growth Panel Regressions

	Dependent Variable: Growth in Real		
	GDP	Private Consumption	Investment
Intercept	40.464	112.015	316.857
	(64.697)	(85.569)	(320.313)
Trade Openness	6.656 ***	6.501 ***	28.185 ***
	(1.370)	(1.782)	(6.796)
Capital Flows to GDP	0.028	0.039	0.038
	(0.047)	(0.062)	(0.234)
Unemployment Rate	-0.279 ***	-0.504 ***	-0.420
	(0.100)	(0.133)	(0.480)
Growth in Population	0.017	0.003	1.218
	(0.836)	(1.105)	(4.141)
Years in Secondary School	4.445	-1.401	-7.838
	(5.304)	(7.019)	(26.300)
External Debt to GDP	-3.172 ***	-3.785 ***	-10.070 ***
	(0.695)	(0.906)	(3.374)
Government to GDP	-0.517	-3.625 *	5.836
	(1.435)	(1.895)	(7.132)
Log(Expected Life)	-13.181	-23.714	-86.586
	(14.659)	(19.362)	(72.599)
Log(1+Inflation)	-4.393 ***	-8.439 ***	-14.231 **
	(1.317)	(1.698)	(6.579)
Local Crisis Dummy	-5.131 ***	-4.863 ***	-23.702 ***
	(0.912)	(1.204)	(4.519)
$Log(Growth)^{\dagger}_{-1}$	0.098 *	0.135 **	-0.052
	(0.054)	(0.053)	(0.056)
Year and Country Fixed Effects	Yes	Yes	Yes
Adjusted R^2	0.555	0.462	0.304
F-statistic	10.180***	7.310 ***	4.210 ***
N	355	355	355

Foreign Bank presence not exogenous to economic conditions

- **Need to distinguish between faster growth from impact on volatility**
- **Therefore control in first stage regression (Morgan & Strahan 2004)**

Global Financial Crisis (2008/2009)

- **Globalisation of banking enhanced the international transmission**
- **A large-scale highly correlated shock → Estimate panel with Common Correlated Effects (Pesaran 2006)**

Local Crisis dummy

- **Too much focus on GFC (2008/09) – look beyond**
- **Local crisis dummy (Laeven & Valencia 2012) excludes volatility due to banking, currency and sovereign debt crises between 1998-2011**
- **Does foreign bank involvement reduce number of crisis?**

More controls in volatility equation

- **e.g. volatility due to commodities (Brazil), terms of trade, foreign demand, regulatory set-up etc.**