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"Lending by example": Direct and indirect effects of foreign banks in emerging markets[☆]

Mariassunta Giannetti [a,b,c,*], Steven Ongena [b,d]

[a] Stockholm School of Economics, Sveavägen 65, Box 6501, SE-113 83, Stockholm, Sweden
[b] CEPR, United Kingdom
[c] ECGI, Belgium
[d] CentER, Tilburg University, PO Box 90153, NL 5000 LE Tilburg, The Netherlands

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ABSTRACT

Using a novel dataset that allows us to trace the bank relationships of a sample of mostly unlisted firms, we explore which borrowers are able to benefit from foreign bank presence in emerging markets. Our results suggest that the limits to financial integration are less tight than the static picture of firm-bank relationships implies. Even though foreign banks are more likely to engage large and foreign-owned firms, after an acquisition, a bank is 20% less likely to terminate a relationship with a firm if the acquirer is foreign rather than domestic. Most importantly, within a credit market, firms appear to have the same access to financial loans and ability to invest whether they borrow from a foreign bank or not, while foreign banks benefit all firms by indirectly enhancing credit access.

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1. Introduction

Capital inflows and entry of foreign financial intermediaries can play an important role in the development of a country's financial system by contributing both investment funds and financial expertise. However, the literature has raised concerns about the limits to financial integration. For instance, only large and visible firms appear to enjoy a reduction in the cost of capital after equity market liberalizations (Chari and Henry, 2004). In environments with high levels of asymmetric information and weak investor protection, agency problems may hamper not only the possibility of issuing equity to foreign investors, but also the banks' ability to lend even in the presence of large amounts of funds (Khwaja et al., forthcoming).

Foreign banks may be even more reluctant than domestic financial intermediaries to lend to opaque borrowers. Warnings about the threat that foreign banks may pose for the domestic banking system have been issued in academic and policy circles alike (Stiglitz, 2002). Foreign banks could poach depositors and safe borrowers from domestic banks while remaining unwilling to lend to local entrepreneurial firms. In addition, foreign acquisitions could disperse the "soft" information local lenders have accumulated.

These concerns are not mitigated by empirical evidence showing that foreign banks are more inclined to lend to large firms with foreign owners (Mian, 2006a; Berger et al., 2001, 2008). However, firms do not need to directly access foreign banks to benefit from financial integration, because foreign entry can provoke changes in the host countries' credit market that potentially affect all firms positively. By poaching more creditworthy and transparent borrowers, foreign banks may induce domestic banks to increase lending to opaque firms

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* Corresponding author at: Stockholm School of Economics, Sveavägen 65, Box 6501, SE-113 83, Stockholm, Sweden. Tel.: +46 8 7369607; fax: +46 8 312327.
E-mail address: mariassunta.giannetti@hhs.se (M. Giannetti).

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(Dell'Ariccia and Marquez, 2004). Additionally, competition may force domestic banks to reduce costs in order to maintain market share (Claessens et al., 2001). Domestic banks may also be spurred to select borrowers more judiciously, if the intensification of competition prevents them from earning rents from creditworthy firms to subsidize connected borrowers. More generally, the removal of restrictions to foreign banks sharpens the threat of takeovers for domestic banks. This threat may discipline managers to improve their lending policies.

In this paper, we investigate direct and indirect effects of foreign bank presence on the real economy. To achieve this goal, we go beyond the static picture of existing literature and assemble a novel dataset that reveals the bank relationships for a representative sample of mostly unlisted firms located in a set of emerging markets in which foreign bank presence substantially changed during the sample period. Importantly, also in our sample large and foreign-owned firms are more likely to establish relationships with foreign banks and large sectors of the economy remain excluded from foreign lending. To test whether this implies a direct harm or positive indirect benefits for the real economy, our empirical strategy follows the following steps.

First, we ask whether foreign bank entry decreases access to the banking system for some borrowers. In particular, we test whether relations are more likely to be terminated after a foreign acquisition. If this is not the case, the fact that foreign banks merely engage large and visible borrowers may be due to the low state of development of the banking system that allows only the most creditworthy borrowers to be reached.

Second, we test whether foreign banks increase credit access directly by establishing relationships with previously unbanked firms or indirectly by inducing domestic banks to initiate relationships with these borrowers. Even if the direct benefits are limited, all firms may indirectly take advantage of foreign bank presence if they are able to access credit at similar terms from domestic banks or other informal sources.

Third, we investigate whether having a relationship with a domestic or a foreign bank makes a difference for a firm's ability to use financial loans and performance. Not detecting any differential effects would imply that it is irrelevant which firms are actually engaged by foreign banks. Although no difference in performance between the clients of domestic and foreign banks may suggest that the indirect effects of foreign bank presence are as strong as the direct effects, this finding is also consistent with foreign banks being irrelevant or even hurting firm performance.

For this reason, our final test directly explores to what extent an increase in foreign lending benefits firms without foreign bank relationships and firms with domestic and foreign bank relationships. The presence of indirect benefits from foreign bank entry would imply that firms benefit from foreign bank lending whether they have foreign bank relationships or not.

Our findings suggest no direct harm of foreign bank presence and indirect benefits on the real economy. First, relationships with foreign banks are less likely to be terminated than relationships with other banks, even during the first three years after the acquisition of a domestic bank when restructuring of the loan portfolio is likely to take place. Then an acquired bank is 20% less likely to terminate a relationship with a firm if the acquirer is foreign rather than domestic.

Second, even though foreign banks do not directly expand access to the banking system by establishing relationships with previously unbanked firms, a one-standard deviation increase in the percentage of foreign lending is associated with a more than 10% increase in the number of bank relationships reported in 2005 by previously unbanked firms.

Finally, not only do our results indicate that firms have the same access to financial loans and ability to invest whether or not they borrow from a foreign bank, but also that foreign loans indirectly benefit all firms: following a one-standard-deviation increment in the increase in foreign loans (half of the increase in foreign loans experienced, for instance, by Estonia during the sample period), an average firm is able to increase its leverage by 20%. Firms appear to use their higher leverage to invest as a similar increase in foreign loans results in nearly 40% higher investment. Not only do foreign banks indirectly benefit all firms, but if anything, the effects are larger for firms with domestic banks, the ones that our results suggest to have obtained recent access to the banking system.

The remainder of this paper is organized as follows. Section 2 relates our paper to the literature. Section 3 describes the data. Section 4 studies firm-bank relationships, while Section 5 and Section 6 explore, respectively, the direct and indirect effects of foreign bank entry on firm financing and performance. Section 7 concludes.

2. Related literature

In countries with underdeveloped banking systems, foreign financial intermediaries should increase the supply of finance. Existing theories however cast doubts on the ability of foreign banks to achieve this goal. Foreign banks are often large and centralized and may therefore lack the organizational dexterity to successfully engage small and young firms, which are considered to be particularly opaque (Stein, 2002; Berger et al., 2005). Empirical evidence showing that credit to the private sector may contract in countries following widespread foreign bank entry (Beck and Martinez Peria, 2008; Detragiache et al., 2008) is consistent with the above theories. However, a contraction of bank loans could also be explained by a lack of investment opportunities and a reduction in crony lending. Having no access to borrower financial information, these papers are unable to evaluate whether bank-lending policies negatively affect firm performance or are the result of a more efficient allocation of credit. Even those papers that describe the characteristics of foreign banks' clients are unable to go beyond a static picture, either because foreign bank presence is stable or because only cross-sectional data is available.

Recent papers relate changes in foreign bank presence across countries (or across states within a country) to firm performance and credit access. But while Giannetti and Ongena (2009a) and Bruno and Hauswald (2008) find that foreign bank presence benefits the real economy, Gormley (2010) finds negative effects of foreign bank entry. These mixed results may depend on the fact that changes in foreign bank presence are often accompanied by reforms that affect firm growth and that vary across samples and time periods. Most importantly, these papers do not help to shed light on *how* firms may benefit from foreign bank presence.

The empirical approach we outline below is mostly based on within-country comparisons of firms that have relationships with foreign banks and firms that only engage domestic banks or that do not have any bank relationships. Our approach is thus less subject than the previous literature to the confounding effects of concurrent reforms. Most importantly, it sheds light on the mechanisms through which foreign banks affect the real economy.

3. Data and sample characteristics

3.1. Data sources and sample construction

The most important data source is a directory of firms distributed by *Kompass*. Kompass provides directories for over two million firms in 70 countries including firm address, executive names, industry, profits, turnover, date of incorporation, and, crucially for our purposes, the firm-bank relationships. Kompass collects data using information provided by chambers of commerce and firm registries, but also conducts phone interviews with firm representatives. Firms

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