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Do global banks facilitate foreign direct investment?

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ABSTRACT

The wave of globalization in finance during the last decades led to the rise of global banks. Are these merely costly liabilities to the countries that supervise them, or is their global reach also beneficial for the real economy and for FDI in particular? Recent literature has focused on the risks, emphasizing transmission of shocks from one country to many countries. On the positive side, this paper hypothesizes that global banks have made investing abroad easier and more successful for their home-market customers. Using a new detailed data set of outward FDI, this paper finds that banks' direct investment abroad is positively associated with the volume of non-financial FDI from the same home market. The result is robust to various robustness exercises which show that the main results are not likely to be driven by reverse causality. The effect is stronger in countries where investing is more hazardous, those with worse corruption and weaker rule of law. Conversely, this paper does not find evidence that host-market domestic or third-country foreign banks facilitate FDI.

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1. Introduction

The wave of globalization in finance during the last decades led to the rise of global banks.[2] Are these merely costly liabilities to the countries that supervise them, or is their global reach also beneficial to the real economy? Recent literature has emphasized the risks of financial globalization, through which shocks are transmitted from one country to many countries (i.e. Cetorelli and Goldberg, 2012; Kalemli-Ozcan et al., 2013a,b). Reflecting this, the recent crisis has turned public opinion against too-big-to-fail multinational banks, because saving them has turned out to be costly for taxpayers.

However, this paper argues that one undervalued benefit of large international banks is their role in facilitating direct investment in foreign markets. In particular, firms wishing to expand abroad through foreign direct investment may find the services offered by multinational banks essential to overcome information asymmetry and foreign market frictions. Retrenchment of banks may thus have real costs. Hale (2012) shows the importance of banking networks to overcome home bias in investment, which itself can be rationalized by information asymmetry.[3] International banks decrease information

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[1] The views expressed are those of the author and do not necessarily reflect official positions of De Nederlandsche Bank.
[2] Milesi-Ferretti and Tille (2011) document the growth of international banking before 2007.
[3] See Veldkamp and Van Nieuwerburgh (2009) for a model on home bias and information asymmetry.

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asymmetry and thereby lower barriers to invest abroad. Because local financial frictions and host-market risk affect the capital structure and constrain investment decisions of multinationals (Desai et al., 2004, 2008), they may well benefit from improved intermediation. This may explain why foreign firms tend to use foreign banks (Giannetti and Ongena, 2012). Such improved intermediation may be realized through increased banking FDI.

This paper provides, to the best of my knowledge, the first evidence that FDI by banks subsequently boosts FDI by non-financial firms. This is a novel addition to the conventional notion that banks follow customers abroad (i.e. Goldberg and Grosse, 1994), although more recent research finds that banks, just like other firms, are sensitive to distance and local market potential in host countries and do not necessarily follow customers (Focarelli and Pozzolo, 2008). Banks may first enter a foreign market in the wake of one of their customers, but once a bank has entered, its services may subsequently attract other firms. Although both directions of causality cannot be separated completely without a controlled experiment, the association of banks leading to more non-financial FDI in favor of the reverse channel is supported by several robustness exercises.

In order to test the hypothesis, data is required that separately identifies banking FDI and non-financial FDI and has enough variation across years and host countries. Restricted access data are provided by the central bank of the Netherlands (DNB), which provides a new data set of outward FDI from the Netherlands. The data uniquely allow separation of banking FDI from non-financial FDI. For example, the foreign positions of US multinationals as collected by the US Bureau of Economic Analysis (BEA) do not allow separation of all banks from other FDI. Moreover, the DNB data can distinguish other financial FDI such as financial holding and letterbox companies. These are excluded from the analysis, which addresses the issue of tax avoidance as a motive for FDI. The raw data represent the population of outward FDI and cover 19 years (1984–2002) and 190 host countries. Dutch FDI represents almost 6% of world FDI, ranking fifth after the United States (which represents 18%) according to UNCTAD (2008). About 71 countries received banking FDI between 1984 and 2002. After conditioning on relevant control variables the main regressions are able to include 55 countries and 17 years in which no observations are dropped due to taking logs of the dependent variable, which limits selection bias.

The empirical strategy first establishes that outward FDI is non-stationary and integrated of order 1. Consistent estimation would require estimation in first differences. However, further tests also establish co-integration, which allows estimation of the error-correction representation which combines level (or 'long-run') effects with first differenced (or 'short-run') effects. This yields joint identification of permanent shocks that affect the equilibrium level of FDI stocks (as defined by a modified gravity model), from short-run effects due to transitory shocks. The paper then shows that (lagged) banking FDI predicts non-financial FDI, conditional on fixed year and country effects and a range of control variables that may both correlate with banking and non-financial FDI, including overall financial development and the volume of lending. A one standard deviation permanent increase in the stock of banking FDI, of about 60%, increases the long-run equilibrium level of non-financial FDI by 10%. Although causality is difficult to establish, the paper performs several tests which conclude that reverse causality is at least not likely to drive the main results.

To shed more light on the mechanism behind the main result, the paper shows that the effect of banking FDI on non-financial FDI is much stronger in countries with weak institutions where information asymmetry is larger and investing is more hazardous, but that the same does not hold true for the extent of third-country banks in the host country, which could have provided a substitute for home-country bank services. In countries with weak rule of law or high levels of corruption, a one standard deviation permanent increase in the stock of banking FDI (of about 60%) increases the long-run equilibrium level of non-financial FDI by up to 14.4%. The effect of domestic and third-country banks is positive, but mostly not significantly different from zero.

Taken at face value, the novel implication for policy makers is that firms benefit from internationalization of the banking sector. However, the presence of home-country banks in host countries is neither the sole nor a necessary determinant of FDI. A welfare assessment will have to weigh the possible financial risks – such as those related to contagion – against the real benefits of an international banking system found in this paper.

The paper is structured as follows. Section 2 discusses the literature and Section 3 the data. Section 4 describes the estimation strategy. Section 5 presents preliminary regressions in levels, dynamic regressions that separate equilibrium from short-run effects, and investigates whether reverse causality is driving the main result. Section 6 explores heterogeneity in terms of bank nationality, institutions and sector-specific effects. Section 7 concludes.

2. Related literature

To explain the pattern of foreign direct investment across countries, models of FDI have mostly focussed on gravity models of market potential, and the spatial organization between parent firms and affiliates in which local production cost advantages are traded off with transportation .[4] More recently, the evidence suggests that only the most productive firms can successfully expand abroad on their own while less productive firms serve domestic markets (i.e. Helpman et al., 2004). This view has also been applied to model the cross-border activities of international banks (Buch and Lipponer, 2007;

[4] High transportation costs predict horizontal FDI to serve the local market by means of local production instead of costly trade (Markusen, 1984) while significant production cost advantages predict vertical FDI where the final good is shipped back to home market consumers (Helpman, 1984). Export-fragmentation FDI allows fragmentation of the production process by producing through intermediaries in different countries, and shipping the final good back to the parent or another country (Yeaple, 2003).

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