Journal of Financial Economics 104 (2012) 89–117

Contents lists available at SciVerse ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

(Interstate) Banking and (interstate) trade: Does real integration follow financial integration? ☆

Tomasz Michalski [a], Evren Ors [b,c,*]

[a] Department of Economics and Decision Sciences, HEC Paris, 78351 Jouy-en-Josas, France
[b] Department of Finance, HEC Paris, 78351 Jouy-en-Josas, France
[c] Centre for Economic Policy Research, 53-56 Great Sutton Street, London EC1V 0DG, UK

ARTICLE INFO

Article history:
Received 6 October 2010
Received in revised form
16 May 2011
Accepted 1 June 2011
Available online 21 December 2011

JEL classification:
F15
G21
G28
R12

Keywords:
Trade
Banking deregulation
Finance–growth nexus

ABSTRACT

We conjecture that banks present in two regions charge the appropriate risk premiums for trade-related projects between these markets, whereas higher rates are charged for projects involving shipments to markets where they are absent. These differences affect regional trade flows. US interstate banking deregulation serves as a natural experiment to test our model's implication with the Commodity Flow Survey data. Difference-in-differences estimates suggest that the trade share of state-pairs that allowed pairwise interstate entry increased by 14% over 10 years relative to non-integrated state-pairs. Instrumental variables estimates suggest that an actual increase in bank integration from zero to 2.28% (the mean) increases trade 17% to 25%.

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1. Introduction

A significant body of empirical evidence, accumulated since the seminal work of King and Levine (1993a, b), indicates that the development of the financial sector furthers economic growth. More recently, research has focused on the channels through which this observed growth may take place. For example, Black and Strahan (2002) show that US intrastate branching and interstate bank entry deregulations between the mid-1970s through mid-1990s had positive and separate impacts on entrepreneurial activity in the form of new business incorporations. Another literature examines the link between financial sector depth and international trade. For example, Manova (2008a) finds that financial liberalization increases country-level exports more in finance-dependent industries as well as in sectors with fewer tangible assets. Finally, a more recent line of research examines

☆ We are grateful for the financial support from the HEC Foundation. We are thankful for the comments and suggestions made on earlier versions of this paper by Stijn Claessens (the referee), Ahmet Aysan, Thorsten Beck, Lamont Black, Astrid Dick, Charles A. Jeffrey, Ed Kane, Bill Kerr, Yrjö Koskinen, Jacques Olivier, and Federico Sturzenegger, the 2009 HEC Paris Economics Workshop audience, as well as session participants at the 2010 Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, 2010 European Financial Association Conference in Frankfurt, 2010 European Economic Association Conference in Glasgow, 2010 Bank of Finland/CEPR Conference in Helsinki, and 2010 Bank Research Conference of the FDIC/JFSR. We also would like to thank Morgan Cullen for providing us with state legislator data and Onur Dalliag for research assistance. All errors remain our own.

* Corresponding author at: Department of Finance, HEC Paris, 78351 Jouy-en-Josas, France. Tel.: +33 1 3967 7123.
E-mail address: Ors@hec.fr (E. Ors).

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doi:10.1016/j.jfineco.2011.11.004

whether banking crises caused credit supply shocks in international trade. For example, Paravisini, Rappoport, Schnabl, and Wolfenzon (2011) find that such negative shocks caused a 15% drop in Peruvian exports during the 2008 financial crisis.

Drawing from these strands of literature, we study a channel of the finance-growth nexus that has received little attention until recently: the effect of banking integration on interregional trade. Specifically, we examine whether the advantage that multi-regional banks possess in resolving information problems has implications for trade across regions. For the main channel, we argue that multi-market banks would make use of the additional information that they gather through their network due to their presence in different economic environments by sharing it among affiliated institutions. This conjecture relies heavily on the assumptions that (i) multi-regional banks operating in a financial conglomerate collect proprietary information on *local* economic conditions *and* (ii) that they share this information with other affiliates. There is empirical evidence supporting both legs of this conjecture in the literature, even if in different contexts. Regarding the importance of locally collected information, Coval and Moskowitz (1999, 2001) show that US fund managers exhibit a local bias in their portfolio choices, which results in higher returns; whereas Malloy (2005) and Bae, Stulz, and Tan (2008) show that local (domestic) analysts make more precise earnings forecasts than non-resident (international) analysts, respectively. Regarding the importance of information flows within a financial conglomerate, Liberti and Mian (2009) show how geographical and hierarchical distance between the loan officers and their supervisors affects loan decisions, providing evidence of various information flow-related frictions within a bank; whereas Mester, Nakamura, and Renault (2007) and Norden and Weber (2010) show that information generated through corporate deposit accounts can be and is used to improve lending decisions. Finally, Ivashina, Nair, Saunders, Massoud, and Stover (2009) and Massa and Rehman (2008) show that information is shared between bank and non-bank affiliates of a financial conglomerate even when regulator-imposed firewalls forbid such flows.

In our context, the comparative advantage of multi-regional banks in collecting and sharing information, vis-à-vis single-market banks, would be put to use for projects that involve trade between the markets in which the bank is present when evaluating loan applications (either for higher amounts of borrowing on existing lines of credit for increased working capital needs, or for setting up new lending relationships), monitoring loans, and pricing financial services. If so, the resulting trade patterns would not be random, but would be instead influenced by the multi-market banks' comparative advantage in information gathering over the regions in which they are present. A mere increase in capital availability due to banking integration, on the other hand, would lead to a general increase in trade volumes, without any *directional* effects on interstate trade patterns. To the best of our knowledge, we are the first to provide tests of directional trade flows following financial integration.

This point can be formally made in a stylized, partial equilibrium model of interregional trade (Michalski and Ors, 2010), in which banks in a given region evaluate loan applications for local manufacturing projects whose target market is another (non-overlapping) region. Banks with a presence in both the manufacturing and the product-destination regions charge appropriate risk premiums on loans for approved projects, given the region-specific information that they already possess. The appropriate (ex ante) pricing and allocation of loans increases trade as the projects with the higher ex ante chance of success are provided capital at lower costs when the bank is present in the target market. The resulting trading activity is not ad hoc but instead shows patterns indicative of multi-region banks' superior ability in capital allocation. If banks have no presence in the target market, they charge an average risk premium that reflects their expectations of the overall probability of success of the average project targeting the unfamiliar product market: projects with a higher chance of success experience a higher cost of capital. As a consequence, trade shares would be lower between regions without integrated banking systems due to a less efficient capital allocation process.

We use the 1977 and 1993 Commodity Flow Survey (CFS) data on interstate shipments among the 48 contiguous US states to test these conjectures. The staggered deregulation of the US interstate banking restrictions serves as a natural experiment that provides variation in financial integration across both state-pairs *and* time that is useful in identifying the effects of financial integration on trade shares. Between the late 1970s and mid-1990s, various states deregulated their banking markets and opened up to competition from other states' financial institutions at different points in time. Many states formed agreements allowing banks from particular states to enter their markets, typically, but not always, on the basis of reciprocity. This resulted in the expansion of Multi-Bank Holding Companies (MBHC) across state lines through acquisitions of individual banks. During the period that we study, banking integration across states evolved solely through MBHCs until the Interstate Bank and Branching Efficiency Act (IBBEA), also known as the Riegle-Neal Act, became effective in 1995 and allowed interstate branching.

When we examine trade patterns across state-pairs in the period that followed interstate banking deregulation, our results support the implications of our stylized theory of trade. We find that for a given state, the interstate trade *share* (i.e., *relative* trade flow) increases more with states with which bank entry was deregulated at an earlier date than with states with which no such deregulation was undertaken (due to data restrictions, we cannot study absolute trade flows). In other words, state-pairs that allowed their financial institutions entry to each other's banking markets are associated with an increase in trade shares (by approximately 14% in 1993 with respect to 1977) compared to state-pairs that have no such common bank-entry deregulation. Looking at actual bank-entry data, our preferred estimate suggests that an increase in banking integration from zero to 2.28% (the mean of the

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