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How does banking sector globalization affect economic growth?

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The present study examines the impact of banking sector globalization on economic growth for a panel of 138 nations spanning 1995–2013. Employing different econometric models, the study finds greater banking sector openness to reduce economic growth. Such finding holds in both emerging markets and low income countries, and in nations with more than 10 percent foreign banks, but not in advanced economies. The paper also finds foreign banks reduce private credit flows in host nations. This implies foreign banks face informational bottlenecks that hinder them from lending to a large majority of potential client-base in host markets.

1. Introduction

The last two decades have seen a rapid increase in the process of banking sector globalization. However, arguments supporting a policy of openness towards the banking industry in a host nation are far from universally accepted. In the aftermath of the recent global financial crisis (henceforth GFC), there has been considerable academic focus and policy attention on the roles of foreign banks in creating economic vulnerability in host countries (Cetorilli & Goldberg, 2012a, 2012b; De Haas & Van Horen, 2011; Drakos & Kouretas, 2015). There is a growing body of literature that has explored different implications of banking sector globalization on topics ranging from its impact on bank profitability and cost efficiency (Claessens, Demirguc-Kunt, & Huizinga, 2001; Claessens & Lee, 2003; Lensink & Hermes, 2004); credit flows (Detragiache et al. 2008; Giannetti & Ongena, 2012; Gormley, 2010; Pontines & Siregar, 2014; Vogel & Winkler, 2012) to financial stability (Claessens and Van Horen, 2012; Demirguc-Kunt, Levine, & Min, 1998; Galindo, Izquierdo, & Rojas-Sua´rez, 2010; Mishkin, 2006; Moreno & Villar, 2005). However, an aspect of banking sector globalization that has been less studied is its impact on economic growth. Although a sizable body of research has explored the effect of financial development on growth (Beck & Levine, 2004; Ductor & Grechyna, 2015) there is scant literature that has focused on the effect of foreign bank entry on economic growth per se. This study examines this issue by using a panel dataset of 138 nations encapsulating 1995–2013.

Conceptually foreign banks may positively influence economic growth both directly and indirectly. By bringing additional capital, energetically seeking profitable use of these funds, exerting corporate control, and facilitating better risk management practices, foreign banks may directly boost capital accumulation and efficiency of resource allocation in ways that accelerate growth (Levine, 1996). Foreign banks may also spur growth indirectly by intensifying competition. By contesting markets and sharpening competition, foreign banks can raise the overall level of banking sector efficiency. Their entry forces domestic banks to provide

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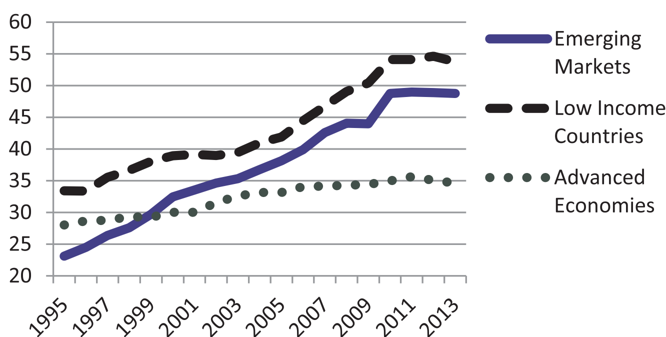

Fig. 1. Percentage of foreign banks to total banks.

better services; domestic banks also become better at mobilizing savings, vigorously seeking profitable use of these savings, exerting better corporate control, and easing risk management in ways that accelerate economic growth (Demirguc-Kunt et al., 1998; Tschoegl, 2005).

In stark contrast to these viewpoints, those against the entry of foreign banks into host countries argue that foreign banks tend to "cherry pick" the most profitable borrowers, leaving the small and medium sized firms unattended who are likely to be informationally opaque. If this argument is justified, a high level of foreign bank penetration may hurt the economic growth of host countries since small and medium sized firms represent usually the largest group of total enterprises and hire a large share of employees (Cull & Peria, 2007; Berger, Miller, Petersen, Rajan, & Stein, 2005). Foreign banks may also lack local information; a major problem in low income countries (LICs) and even to an extent in emerging and developing market economies (EMs) where asymmetric information problems are severe and legal enforcement is weak (Acharya, Sundaram, & John, 2004; Petersen & Rajan, 1995). In addition foreign banks are often large organizations and reluctant to decentralize decision power. However, decentralization is necessary if lending decisions need to be based on soft information, based on relationships of banks with prospective local clients and knowledge about local market conditions. This is often the case when dealing with small firms, dominant in LICs and EMs. As a result, the local branches of foreign banks may specialize in funding large firms and overlook small firms. Such neglect may create concerns that foreign bank presence may be detrimental to the financing and growth of small and young businesses (Giannetti & Ongena, 2012). This may actually lower overall economic growth, especially in LICs and EMs.

Empirical studies examining the impact of foreign banks on economic growth are not only sparse but also provide ambiguous results. Demirguc-Kunt et al. (1998) using data on 7900 individual commercial banks covering 80 nations for the period 1988–1995, is one of the very few studies that has addressed this issue. The authors find, foreign banks do not exert a significant impact on economic growth. Wu, Jeon, and Luca (2010) using country level data on 35 emerging economies for 1996–2003 and employing both OLS and fixed effects models, find greater foreign bank presence to have an insignificant impact on growth (and in fact negative in one specification), but when interacted with capital formation growth is statistically significant in positively affecting economic growth. This leads the authors to conclude that the effect of gross fixed capital formation on output growth is higher in an economy with a more pronounced level of foreign bank penetration relative to those with a lower level of foreign bank penetration.

In this context, this paper makes a contribution to the literature on banking sector globalization. Using three different measures of banking sector openness, I examine their impact on economic growth while controlling other macroeconomic and relevant determinants of growth. I cover the widest possible range of nations for the most updated time period 1995–2013. Furthermore, the results are compared across different levels of economic development: EMs, LICs and advanced economies (AEs).[1]

From a policy perspective, economic success of any nation intrinsically hinges on the tradeoff between external policy choices and their internal consequences. One such external policy choice is the extent of banking sector openness. Hence, in guiding economic policy, the findings of the analysis will shed light on regulatory measures for central bankers and governments. This study will either exacerbate or ameliorate previous findings on the impact of foreign banks on economic growth in host countries.

The remainder of the paper proceeds as follows. Section 2 provides some trends and patterns on the extent of banking sector globalization and economic growth. Section 3 discusses the determinants of economic growth and the different econometric models. Section 4 presents the results along with several robustness checks. Section 5 examines the impact of foreign banks on credit flows. Finally, Section 6 concludes.

2. Trends and patterns in banking-sector globalization and economic growth

2.1. Measuring banking-sector globalization

There are primarily two reasons that drive foreign banks to enter another country. First, in search of higher profits and more diversification opportunities. Foreign banks have entered a host nation either through extending branches and subsidiaries of parent banks or through mergers and acquisitions with private banks in the host nation. Secondly, governments of host nations have

[1] These nations are categorized under these categories following the World Economic Outlook (2012) of the IMF.

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