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ABSTRACT

The impact of greater foreign bank presence on domestic monetary policy transmission has become a subject of importance for emerging and developing economies (EMDEs) as several of them have gravitated towards more market determined exchange rate regimes and consequent use of interest rates as the primary instrument for macroeconomic management. In this paper, we explore the impact of foreign bank presence on interest rate pass-through for a panel of 57 EMDEs over the period 1995–2009. Our empirical results suggest that there are strong threshold effects in terms of foreign bank presence and its impact on the strength of interest rate transmission. Foreign bank presence tends to reduce lending rates and enhance interest-rate pass-through in countries that have a relatively high degree of foreign bank presence compared to those with limited presence. On the other hand, foreign banks do not play any significant role in interest rate transmission in low threshold economies. We further find that the when foreign bank presence is associated with a decline in banking competition, it appears to lower the interest rate transmission.

1. Introduction

Since the 1990s, several emerging market and developing economies (EMDEs) have been opening up their borders to cross-border capital flows. Openness to capital flows has broadly involved a combination of capital account openness to different degrees as well as the internationalization of the financial sector featuring foreign bank entry. Notwithstanding the variations in the degree and scope of their involvement between regions and countries, foreign bank presence has grown significantly across-the-board in EMDEs. For instance, Sub-Saharan Africa saw its foreign bank assets rise from an average of just under 40 percent in 1996 to close to 60 percent in 2009 and the corresponding share in Europe and Central Asia rose from 17 percent to 60 percent. Latin America also witnessed a marked change, with shares growing from 17 percent to just over 40 percent on average between 1996 and 2009. Compared to the other regions, the degree of foreign bank presence in East Asia and Pacific, South Asia and the Middle East and Northern Africa has been relatively smaller, though the shares have been rising in importance in those regions as well. While the average share of foreign bank assets doubled

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