

Does Foreign Bank Entry Stimulate Trade and Investment? Evidence from the European Union

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Extended Abstract

While there is a broad literature on foreign direct investment (FDI), industry and sectoral aspects as well as spillover effects have received less attention. Sectoral studies are rather concerned with entry strategies (e.g. Haselmann, 2006). Given the mounting wave of foreign bank entry in emerging markets across the globe and especially in Central and Eastern Europe, it is important to investigate their broader impact. Does financial sector foreign direct investment (FSFDI) trigger foreign trade, direct investment and/or portfolio investment? Do these sectoral inflows to the new European Union member states from Central and Eastern Europe provide positive signals towards economic development or “crowd out” investment and trade? The linkages we investigate are important for management and business in evaluating cross-border opportunities.

We follow the signal theory of Spence (1973) and argue that if banks – investors who are usually perceived as risk-averse and well-informed – enter foreign markets, they send signals of the host country’s competitiveness and thus attract other investors and traders. We hypothesize that the massive inflow of foreign banks may stimulate non-financial FDI, trade and foreign portfolio investment via the provision of signals.

In the theoretical part, we review the literature on possible links and provide descriptive data for formerly communist countries in Central and Eastern Europe. Previous research states that the repercussions of foreign banks on non-financial FDI may result in an overall better performing banking system, since efficiency rises due to the increased number of new and potential entrants (Cárdenas et al. 2003, 3). Effects on trade are not that evident, since many studies state that a high level of trade leads to an increased number of foreign banks, thus neglecting the opposite direction of repercussions. However, surveys underline the importance of a well-functioning banking system for the emergence and improvement of export industry (e.g. Roldos 2001) and Brealey and Kaplanis (1996) suggesting a likely relationship between the location of overseas offices of large banks and trade. As to foreign

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banks' impacts on foreign portfolio investment (FPI), there is a lack of empirical surveys. However, De Santis and Ehling (2007) contributed to research by proving that FDI sends signals to foreign portfolio investors. Furthermore, since foreign bank penetration is expected to improve the banking sector's efficiency, it is assumed that the level of foreign portfolio investment is affected as well.

In the empirical part, we conduct panel regressions with fixed-effects and tobit regressions in order to test for the association between FSFDI and non-financial FDI/trade/FPI. The survey focuses on the New EU Member States plus Croatia covering the years between 1997 and 2006, thus focusing on the period when the level of FSFDI surged considerably.

The panel regressions provide interesting and new results: First, regarding the link between FSFDI (modeled by the asset share of foreign-owned banks) and non-financial FDI, the tobit regression states a positive association between the two variables, thus confirming the signal channel. Although causality might be blurred, we argue that it is FSFDI that triggers non-financial FDI since foreign banks do not only finance affiliates of clients from their home countries (Clarke et al. 2001) and since it is likely that foreign banks promote FDI by improving the banking system's efficiency (Cárdenas et al. 2003). Concerning the control variables included in the regression, GDP, taxes, inflation, infrastructure (telephone mainlines) and a dummy for EU membership are positively correlated with non-financial FDI. Finally, the more corrupt the host country's business environment is, the more non-financial FDI stocks are registered. Consequently, the positive view of corruption holds true, i.e. corruption triggers FDI in transition countries by facilitating transactions (Cuervo-Cazurra (2008, 14).

Second, the tobit regression testing for the relationship between FSFDI and merchandise trade shows a positive association. We argue that foreign banks influence trade flows and not vice-versa, because financial markets enhanced by foreign banks facilitate trade, wherefore foreign banks may send signals to exporters or importers that trade flows are easier to implement and that the integration of the host country may be enhanced thanks to foreign banks and their efficiency spillovers on the host country. Regarding other variables, air transport and total FDI inward stock are both positively correlated with trade, and the more corrupt the host country's business environment is, the less trade flows are registered. Finally, the distance of the host country's capital to Brussels is negatively associated with trade flows. However, by conducting separate regressions for exports and imports, FSFDI turned out to be insignificant in the case of merchandise exports, but positively correlated with the level of merchandise imports. This confirms results of Mencinger (2003, 12) who suggest that the higher the inflow of FDI into a country, the higher its current account deficit. Consequently, on the one hand, FSFDI enhances economic integration by triggering trade flows; on the other hand, it leads to an increase in the current account deficit, which obviously is not a favourable situation for the host economy.

As to the link between FSFDI and foreign portfolio investment (FPI), there is no significant association between the two variables. This might be explained by the fact that large domestic banks are often delisted from local stock exchanges after takeovers by foreign-owned banks (Mihaljek 2006, 59), thus decreasing stock market capitalization. Moreover, it might be reasonable to include lead effects, because the entry of a foreign bank usually is evident and known to the public some years before the actual investment, wherefore signals of FSFDI to potential portfolio investors might start earlier than at the time of the actual entry. However, by including a lead of one year of FSFDI, the asset share of foreign-owned banks is significantly negatively correlated with FPI. One might explain the negative correlation between FSFDI and FPI in two ways: Either the entry of foreign banks decreases the confidence foreign investors have in the host economy, or FSFDI substitutes

FPI. The first assumption could be affirmed if it is true that financial crises are feared by investors if the banking industry booms, whereas the latter would be affirmed if foreign banks themselves realized FPI before substituting these kinds of investment by entering the foreign market via direct investment, which in turn decreases foreign portfolio investment. Concerning the included control variables, stock market capitalization and GDP both show positive coefficients. The rule of law is negatively correlated with FPI, which might be due to difficulties in the interpolation of some data points or due to assumption that FPI flows in despite some corruption. Finally, non-financial FDI (and in some cases also total FDI inward stock) is significantly positively correlated with FPI, which confirms results of De Santis and Ehling (2007) who showed that international portfolio investors follow firms' foreign investment decisions (De Santis and Ehling 2007, 26).

To conclude, our empirical results suggest that financial sector foreign direct investment can trigger growth in foreign trade and in FDI into other sectors, but is less conducive to foreign portfolio investment into the host country. Trade and FDI follow the signals from massive bank entry. We provide evidence of positive spillover effects of sectoral FDI from banking to other sectors. We argue that by attracting trade and investment, foreign bank investment is conducive to economic development and the competitiveness of Central and Eastern Europe. We suggest that the cross-border moves by banks need to be taken into consideration by management and business in other industries in shaping their internationalization strategies. We find that these indirect FDI effects also need to be taken into consideration by public policy and that they deserve further empirical investigation.

Key Words: foreign banks, signal theory, foreign trade, foreign direct investment, portfolio investment, sectoral effects, spillover effects

JEL-codes: E44, F15, F36, G21, O11, P34

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