Cross Border Banking and International Transmission of Financial Distress

Discussion by:

Philip E. Strahan
Boston College & NBER
June 2010
Broad Questions

- Does bank distress reduce credit supply?
- Do small, risky firms suffer more in face of credit crunch?
- Does financial integration propagate shocks internationally?
- Do foreign banks cut lending more than domestic banks?
Specific questions

- Do SMEs report being more constrained if local banks are more distressed?
  - Paper removes banks reporting no need for a loan.

- Are effects larger when foreign banks have more market share?

- Do smaller and riskier firms report greater sensitivity to distress of local banks?
Basic model:

\[ \text{Borrower Constrained}_{i,j,k} = \beta^2 \times \text{Bank Capital}_{j,k} + \ldots \]

What generates \( \beta^2 \)?

- Credit supply reduced when bank capital is low (desired effect)
- Composition of credit demand may be weak where capital is impaired
- Reverse causality: Bank capital may be low when borrowers are distressed
Identification

- Remove demand bias using Heckman style correction
  - What are the identifying instruments?

- Use of small countries with large foreign bank presence helps with reverse causality
  - But complicates tests of the impact of foreign banks...
What is being measured?

Between 2005 to 2008 (Table 3)

- Fraction reporting a need for credit falls by 17% on average, and it falls in all 14 countries
- Fraction reporting being constrained FALLS by 7.9% (8 fell, 6 increased)

Correlations (Table 3)

- Change in capital v. Change in credit demand = 0.48
- Change in capital v. change in share constrained = -0.02
Change in Share Needing a Loan

Change in Bank Capital, 2008 - 2005
Change in Share Rejected or Discouraged

Change in Bank Capital, 2008 - 2005
Across v. within country

All regressions are generated by within country variation

- How local are banking market across small countries like Bulgaria, Slovenia, Slovakia, etc?
- How much variation is left after removing the country effects?
- Do standard errors account for within-country clustering?
Summary

Paper emphasizes tradeoffs of financial integration

- Benefits: more competition, more capital, faster growth
- Costs: financial instability from abroad

Empirical extensions

- More analysis of demand
- More details on nature of local banking in Eastern European economies