Implications of the Globalization of the Banking Sector: Discussion

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First of all, congratulations to the authors, Joe Peek and Eric Rosengren, are in order: This is an interesting paper, it is an important topic, the ideas are excellent, and the analysis is of high quality. But having said that, my job is, of course, to be somewhat critical. Not too much value is added just in congratulating the authors. My comments will be closely tied to the paper, starting with a general point and then turning to some more specific issues that are raised in the paper. I will, however, make a couple of digressions along the way that are related to some important aspects raised during the conference.

A General Comment: Latin America Is a Land of Opportunity, Not Just of Crisis

My first general comment is that, given the title of the paper, I was expecting something broader. The title is "Implications of Globalization" but the paper focuses more narrowly on globalization and its effects on the likelihood of crises and issues of financial stability. To do justice to the title, the authors should consider Latin America as a land of opportunities, not just a land of crises, and attempt to understand why we have seen this globalization process developing and the motivation of the institutions involved. If we understand the motives behind the process, then we should also be able to predict better how these institutions might behave under different circumstances—including the occurrence of a crisis in a particular country.

Regarding the motivations for the globalization process in banking,

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let me make a couple of remarks with respect to Argentina, which I am sure are relevant elsewhere as well. A first important fact is that the banking sector is clearly no different from other sectors. In terms of cumulative foreign direct investment (FDI) flows into Argentina from 1992 to 1999, the banking sector is only in fourth place, behind petroleum, the manufacturing sector, and utilities. In terms of globalization, then, nothing is special about banks—at least not in the case of Argentina—and it is likely that the motivations that lie behind the FDI flows in the banking sector have a lot in common with the motivation behind the flows in other sectors.

Considering the banking sector in a little more detail, foreign banking groups have made a significant number of purchases of local banks in recent years—adding to the already significant foreign bank presence in Argentina, which has over a century of history. It is also interesting to note that the purchasing institutions, such as Grupo Santander, Grupo Bilbao Vizcaya, and HSBC, have also made significant purchases in other countries of the region. So, again, it is likely that the motives have as much to with the strategies of these institutions (and the characteristics of their home markets) as with particular opportunities seen in Argentina or elsewhere.

I would suggest to the authors that they consider the motives and strategies of these international banks, which have really been the instrument of the globalization process. It is clear that the motivation is likely to be a pretty general one, as it seems the process that we have witnessed in the banking sector in Argentina is being witnessed in other countries and also in other sectors. Natural candidates as motivations are, of course, economies of scale, diversification of risks, and simply taking advantage of growth opportunities abroad while domestic markets remain, arguably, more stagnant.

Indeed, many of the sectors that have received large FDI flows in Argentina offer huge opportunities for growth. The banking sector is an excellent example. M3 over GDP is one measure of the size of the financial sector. In Argentina now, it is about 32 percent—higher than Mexico and a little higher than Brazil using comparable aggregates but still a low figure compared to Argentina in the 1940s (about 50 percent), Chile, Europe, and the United States. In the case of Argentina, I would expect the banking sector to continue to grow in coming years as the economy at least reaches historical levels of monetization.

In the case of Argentina over the 1990s, this is in fact a process of re-monetization, following the de-monetization of earlier decades and especially the 1980s. The banking sector was essentially driven offshore, especially during the 1980s, and has now come back onshore again. It is important to keep this in mind and I will come back to this later in my comments.

More Specific Comments

The Currency Board: Foreign Bank Entry and Banking Regulatory Reform

Let me now turn to some more specific comments regarding the paper, and I will then use those more specific points as a springboard for other digressions. The paper, in its discussion of Argentina, places a lot of emphasis on the currency board. The currency board has clearly been an extremely important policy, but in general in discussions on Argentina I find that the existence of the currency board is held responsible for many things that in my view are quite independent.

For example, Peek and Rosengren suggest that, because of the currency board, the Central Bank might have deliberately opted for the strategy of allowing foreign banks to enter. In fact, the entrance of foreign banks in Argentina has had little to do with the currency board policy. In terms of the legal framework, the FDI in the banking sector (as in the other sectors of the economy) is a direct consequence of the investment law, which was passed before the currency board was adopted. The investment law, passed in 1990, establishes that foreign capital should be treated the same as domestic capital. Moreover, the Central Bank has little real power either to allow foreign banks to enter or to prevent them from entering. Prevention would only be appropriate in the case of a bank wishing to enter that did not match up to the right prudential standards. As in other sectors of the economy, it is Congress through the investment law that has allowed a very significant amount of FDI in the banking sector.

Where perhaps the currency board might be thought to be more relevant is in the type of banking sector regulatory reforms that have been undertaken, but once again it is easy to over-stress the role of Argentina's currency board. I often hear the argument that Argentina needed to strengthen banking regulation because of the "straitjacket" of the currency board policy. I cannot overstate how much I disagree with the sentiment behind this statement.

More important, in my view, is the very significant legal and actual independence that the Argentine Central Bank has. Congress has given the Central Bank very wide powers to regulate the banking system. Capital requirements and all the major regulations in the system can be changed by a simple decision of the Central Bank board. I know the board reasonably well, and they are a group of talented and innovative people. I would have expected them to be just as innovative if Argentina had a floating exchange rate rather than a currency board. Hence, presuming the legal powers of the Central Bank were the same, I do not think the regulatory reforms would have been too different either!

The more important and more general point, however, is that no trade-off should be made between banking regulations and a particular monetary regime. If anything, I would suggest that under a currency board, some regulations could be less strict, given that domestic interest rates tend to be lower and more stable, currency mismatches less of a problem, and, all things being equal, economic volatility lower (but I would not argue this point too far). On the other hand, I think it is completely wrong to advocate weaker banking regulations for countries simply because they have a floating exchange rate. The idea that because such countries might be able to bail out banks through printing money (and hence breaking any monetary or inflation target that they may have), these countries have a reason for having less capital against credit or other risks, strikes me as a very strange and dangerous argument indeed! It continually surprises me to hear it repeated in public!

Bank Privatization and Foreign Bank Entry

The Peek and Rosengren paper also refers to the links between the bank privatization process and the entrance of foreign banks. In reality, the privatization process in Argentina has essentially attracted domestic capital. The foreign capital has come in mainly in operations involving existing private banks rather than state banks. In the case of the banking sector, the privatization process and the globalization process have been much more distinct than in other economic sectors in the country, where the relationship between privatizations and FDI flows has been clearly very strong.

Foreign Bank Entry in Argentina: Surprisingly Rapid, or Surprisingly Late?

Peek and Rosengren make many references to the significant extent of FDI in the banking sector in Argentina and also to its speed. I have argued that actually this FDI has been less than in other sectors of the economy, and the puzzle in fact is why FDI occurred later in banking than in other sectors. Why did it take place in 1997 and 1998, rather than in the period 1991 to 1994? One simple answer is that FDI in other sectors was related to particular privatization operations and hence simply depended on the dates of those privatizations. However, significant FDI did enter into other sectors in the 1992–94 period—but not to banks, so this is not the whole answer. The common view within Argentina is that international banks were waiting to see how the currency board would behave in different periods. And once Argentina had gone through the Tequila shock of 1995 and passed this significant "test," then international banks decided that Argentina was a safe place to come in and invest. That view is consistent with the view expressed by Peek and Rosengren that the Tequila crisis in Argentina certainly did not mean that foreigners fled and indeed appeared be the precursor to new flows.

But, as hinted above, this theory may exaggerate the importance of Argentine effects and may overlook the importance of the "push" factors operating on international banks. I suspect developments in international banking were probably just as important; the timing was right.

Foreign Banks: Lenders of Last Resort or Losers of First Resort?

Let me now turn to the actual focus of the paper, the role of foreign banks in crises, and I will first make reference to the experience of Tequila in Argentina in early 1995. This dramatic four-month period when the Argentine financial system lost about 18 percent of deposits (about \$8 billion at the time) prompted a very comprehensive review of liquidity management in Argentina. The \$8 billion outflow was roughly financed by a reduction in reserve requirements (\$3 billion), Central Bank repo and rediscount operations using the excess reserves over the currency board obligations (\$2 billion), a reduction in credit of about \$1 billion, and an increase in foreign credit lines of about \$2 billion. This \$2 billion assistance by foreign banks was essentially directed toward foreign banks in Argentina and to those domestic banks that had very strong links with foreign banks. So it does seem that foreign banks played an important role.

However, the experience was mixed and, in some cases, there were reports of foreign banks cutting credit lines to local subsidiaries. This mixed experience has led the President of the Central Bank in Argentina, Pedro Pou, to remark that foreign banks are not so much a lender of last resort as a loser of first resort! Let me try and explain what I think he means. Basically, if a country has a systemic problem, it would be incorrect and dangerous for the country to believe that foreign banks were necessarily going to bail out the country. It would be the country's problem, which it would need to solve on a systemic basis. However, if an individual foreign bank subsidiary in Argentina had a problem, could not satisfy its capital requirements, for example, it would be entirely correct for Argentina to seek a recapitalization of that foreign subsidiary from its parent. In other words, foreign banks are a loser of first resort, in the case of a problem in that individual bank, but not necessarily a lender of last resort in general to the country. This implies that the presence of foreign banks does not negate the need for what we refer to as a systemic liquidity policy.

Yesterday, Paul Tucker of the Bank of England made an interesting observation about liquidity; let me expand a little on that issue here. Our feeling is that emerging countries probably need to think about liquidity in a different way than the average G-10 country does. Put simply, the trade-off between monetary and financial stability is harsher in an emerging country. The idea that if you had a significant liquidity problem in an emerging country you could inject domestic liquidity, while at the same time sterilizing that intervention through some open market operation, is very much wishful thinking and, in practice, probably impossible.

Our experience certainly has been that any liquidity problem in the financial system is coincident with a drying up of liquidity in the government bond market, and also with a run out of the system from domestic assets to foreign assets. And so, it is almost impossible to think of some kind of sterilized intervention in an emerging country context if you have a significant liquidity problem in the banking system. That means that whatever other target the central bank has, whether it be a monetary target, an inflation target, or an exchange rate target, as in the case of Argentina, you need a liquidity policy to protect that target if you want to pretend to be a lender of last resort at the same time. The only point that I would slightly disagree with Tucker on is the distinction between domestic and foreign currency liquidity. I think that distinction can be overdone.

On the Quantitative Aspects of the Peek and Rosengren Paper

I would also like to make some specific comments regarding the quantitative aspects of the Peek and Rosengren paper and their analysis of the data. First, a comment on the BIS consolidated data. In Argentina, we are sometimes rather critical of these data; let me just explain why. It is because, as stated in the paper, the focus of these data appears to be related to currency risk, and hence interpreting the BIS consolidated data is a very serious problem in a country like Argentina, where more than 50 percent of deposits and 50 percent of assets of the domestic financial system are in dollars. To take an example, when Citibank in Argentina gives a mortgage in dollars to an Argentine resident that is financed by a deposit in dollars from an Argentine resident, that transaction is counted as a cross-border flow in the BIS consolidated data.

In attempting to use these data to think about the liquidity position of Argentina, a serious problem of interpretation arises. However, for what Peek and Rosengren want to do, the data are perfectly fine, because they want to look at broader measures of foreign bank concentration. So not only do they use the BIS consolidated data that include the foreign-currency local assets as mentioned specifically in the Citibank example, but they also add onto that the local-currency local assets of foreign subsidiaries. So, in fact, the data are perfectly fine for their purposes.

Indeed, I think that in general Peek and Rosengren's comments on Argentina, and on other countries to my knowledge, are correct and their interpretations are fine. It is clear in the case of Argentina that the onshore foreign bank penetration has been increasing much more rapidly than the offshore. In some ways this is not very surprising given that, as detailed above, we have had a strong re-monetization process taking place in a period of increasing stability and openness.

But let us suppose for a second that we are close to the end of this process and think about what will determine future onshore versus offshore penetration. Increasingly, this will be governed by the decision of an international bank with a presence in Argentina whether to finance loans onshore or offshore. This decision will of course be related in part to whether domestic funding is available, but it will also be a strategic decision of the bank and will reflect certain structural characteristics including, for example, the tax situation. The paper might want to look more at those kinds of issues.

Moreover, the offshore lending (see Table 2 in the Peek and Rosengren paper) may reflect what the Argentine public sector was doing. In turn, the Argentine public sector may reflect the financing requirement and the decision of the Argentine government on how to finance that requirement, whether it is onshore or offshore. Consideration of these trends might alter to some extent the figures on onshore and offshore penetration, but I do not think they would alter the overall conclusions.

Direct Foreign Lending versus Foreign Lending through Domestic Subsidiaries

The result the authors claim, and I find fascinating, is that the shift from direct offshore to onshore lending through subsidiaries is accompanied by greater lending. In other words, the lending from foreign subsidiaries within a country in the region tends to be more stable than loans directly from foreign banks to domestic companies. This appears intuitive and is I believe quite an innovative finding. However, the evidence in the tables that the authors present is somewhat mixed and, to be fair, does not appear totally conclusive. One aspect that might be affecting the result is that purchase of a domestic bank by a foreign bank may be accompanied by a reduction in other credits to the country, and so direct foreign lending appears as more unstable. I think that the authors propose a perfectly rational view, but we may have to wait a few years before we have the real evidence to conclude one way or the other.

However, assuming that it is the case, my feeling is that a relationship may exist between the concentration of foreign liabilities and the stability of foreign borrowing. In other words, it is probably also the case that this trend to onshore foreign lending has been accompanied by a greater concentration of foreign lending. I suspect that this is true for Argentina and likely to be true for the region as a whole. Indeed, given that that many of the same banks have invested in Argentina, Brazil, and

Mexico, I suspect that considering the region as a whole this is trend is even clearer. I could imagine theoretical models that might justify why greater lending concentration actually breeds greater stability, consistent with the authors' claims.

Conclusions

Let me conclude these comments. I think this is an excellent paper, full of very useful facts, and the interpretations on the whole are excellent. I am broadly in agreement with the main points in the paper. Let me also conclude by making a more general comment regarding the Argentine experience: I believe that the entrance of foreign banks has been extremely beneficial to the financial sector in Argentina. In the work that we have done in the Central Bank, we have found (controlling for the type of bank) no significant differences between the behavior of foreign banks and that of domestic banks, in terms of the relationship with borrowers. However, we think that foreign banks have had a tremendous positive effect on the efficiency and the competitive nature of our financial system. Moreover, they have added to the solidity of the system, and their presence is certainly one factor why investors in the system appear to remain extremely confident with respect to its stability, despite a set of international financial shocks and the recent economic recession in Argentina.