



Editorial

Overview of the special issue on banking, development and structural change

1. Introduction

The focus of this special issue is on three important sets of topic in the fields of international banking and international financial economics: the interaction of finance with economic development and structural change; financial integration in the euro area; and financial stability and the effects of capital regulation. All of have been the subject of a good deal of recent discussion in the scholarly literature.

The articles included in this issue are refereed versions of papers presented at a conference held in Helsinki, Finland in May 2003 that was jointly sponsored by *JIMF* and the Bank of Finland. We open this issue with an overview of these papers.

Before turning to that discussion we wish to thank the discussants and referees who worked on the development of this issue as well as the Bank of Finland for its generous hospitality.

2. Finance, economic development and structural change

Baier, Dwyer and Tamura in “Does Creation of a Stock Exchanges Increase Economic Growth?” re-examine the connection between the creation of stock exchanges and economic growth using a new set of data spanning a much longer time period than used in most conventional studies of the subject. Berger, Buch, DeLong and De Young in their “Exporting Financial Institutions Management via Foreign Direct Investment Mergers and Acquisitions” compare the traditional theory of comparative advantage with new trade theory to explain geographical patterns in international mergers and acquisitions for financial institutions. Saunders and Stover in “Commercial Bank Underwriting of Credit-Enhanced Bonds: Are there Certification Benefits to the Issuer?” expand the commercial bank certification hypothesis to include banks acting in an underwriting capacity, and focusing on the industrial revenue bond market. Qian, John and John in “Financial System Design and Liquidity Provision by Banks and Markets in a Dynamic Economy” contribute to the extant theory on financial system design by comparing markets and banks in a dynamic economy.

Baier, Dwyer and Tamura use data for 24 countries before 1900 in addition to the commonly used post-WWII data set. They are thus able to examine the con-

nection between the creation of stock exchanges and economic growth for both developed countries historically and emerging markets in more recent decades. The results that they obtain indicate that the creation of a stock exchange is associated with higher economic growth in the country in question both before and after the event. Their results show further that the country's economic growth tends to increase relative to growth in other countries once the stock exchange is set up. The authors discuss two theoretical channels through which a stock exchange can affect growth, by increasing the growth rate of the capital stock as in Bencivenga and Smith (1991), and by increasing the efficiency of the economy, as measured by total factor productivity as in Greenwood and Jovanovic (1990). If capital is interpreted broadly to include both physical and human capital, they go on to argue, the increase in the growth rate of the economy from faster capital-stock growth can be permanent. Increasing efficiency of the economy can also have a permanent effect. Of the two, increased efficiency seems to be the more important channel. In their investigation the authors also examine "financial deepening" – proxied by growth in the ratio of broad defined money relative to nominal income – before and after a stock exchange opens. They find that financial deepening is rapid before the creation of a stock exchange but slower subsequently.

Berger, Buch, DeLong and De Young test the relevance of the new trade theory (e.g., Markusen, 1995) and the traditional theory of comparative advantage (Ricardo, 1817) for explaining the geographic patterns of international mergers and acquisitions (M&As) of financial institutions between 1985 and 2000. The authors' goal in this paper is to begin a research agenda that identifies whether some countries, characteristics of countries, or characteristics of country pairs are associated with significant comparative advantage in managing multinational financial institutions through direct foreign investment M&As. Both the new trade theory and the traditional theory receive statistically significant support in the data. The data set includes 1,849 cross-border M&As of commercial banks, insurance companies, and securities firms from 30 countries in Europe, North America, Asia, and Oceania between 1985 and 2000, the characteristics of the acquiring and target countries, and the joint characteristics of the acquirer-target country pairs. The authors test whether the characteristics of home countries, host countries, and/or country pairs are systematically related to the quantity of foreign direct investment in financial institution M&As between the 870 country pairs in their sample. The results show that highly developed economies are more likely to export financial-institution management, and that they are also more likely to import it. Cross-border financial-institution M&As are substantially more likely when the home and host countries are geographically close, share common languages and legal systems, and have similar sized economies and similar levels of economic development. The authors also find evidence of idiosyncratic, country-based comparative advantages for the United States, as well as weaker evidence of such effects for the United Kingdom and a handful of other northern European countries, both in exporting financial-institution management via foreign direct investment M&As and in importing financial-institution management via M&As. These twin findings suggest that something about the U.S. financial environment in particular (a) provides its dom-

estic financial institutions with the ability to overcome the diseconomies of operating in foreign environments, and (b) provides foreign financial institutions with an environment (e.g., access to the largest financial center, low regulatory burdens or cultural barriers) that allows them to overcome similar diseconomies.

Saunders and Stover expand the commercial bank certification hypothesis to include banks acting in an underwriting capacity. The paper develops this research by focusing on the industrial revenue bond market in which banks have the unique opportunity to simultaneously act as both credit guarantor and underwriter. After allowing for bank-issued standby letters of credit (guarantees), the authors find evidence of significantly greater yield spreads for bonds underwritten by commercial banks compared to bonds underwritten by investment banks. Overall, no net gain appears to accrue to the bond issuer when attempting to achieve joint (or double) certification benefits by employing commercial banks as both credit guarantor and underwriters except in the special case where the same bank acts as both guarantor and underwriter. This limited certification effect is further validated when the credit quality of participating banks is accounted for. This result is consistent with an “economy of scope” in monitoring and reusing information.

Qian, John and John compare the roles played by banks and financial markets in providing investors with liquidity. As a theoretical basis for their investigation the authors assume full-fledged dynamic markets with intergenerational trading. They then examine the workings of banks in the context under the alternative assumptions of full and limited participation by banks in financial markets. In their analysis, they address five key questions: How does a full participation market perform in providing liquidity to investors subject to liquidity shocks? Under what conditions do banks provide more liquidity than markets? Correspondingly, when do markets outperform banks in this regard? How does a limited participation market perform? Finally, what can an intergenerational bank offer when financial-market participation is limited?

They go on to show that the full-participation market with intergenerational trading can provide more liquidity than one without such trading. When intergenerational trading takes place insurance is provided through wealth transfer across generations, rather than simply cross-subsidization across contemporaneous types. Given a full-participation market that allows trading across generations, only banks with initial capital can provide additional liquidity. In a limited-participation market with uncertainty about trading types, an intergenerational bank (with or without initial capital) provides additional insurance to investors and the need for trading is eliminated. Finally, if there is no uncertainty about trading types, then an intergenerational bank with initial capital eliminates the need for trading and improves welfare for all.

3. Financial integration in the euro area

In “Measurement of Contagion In Bank Equity Prices,” Gropp and Moerman examine the tightness of the banking links within countries, between all EU coun-

tries and between euro-zone and non-euro-zone EU countries. To examine this issue they focus on within-country and cross-country “shock spread” – which they term “contagion” – among the large banks in the EU. Sander and Kleimeier in their paper, “Convergence in euro-zone retail banking? What interest rate pass-through tells us about monetary policy transmission, competition and integration,” develop models that they apply both to monetary-policy shocks and to changes in the cost of funds to examine the monetary transmission mechanism and the extent of banking competitiveness within the euro zone.

Gropp and Moerman use the co-occurrence of extreme shocks to banks’ risk to examine within-country and cross-country contagion among large EU banks. The alternative measures of bank risk that they use are the first difference of weekly distances to default and abnormal returns. Using Monte Carlo simulations, the authors examine the question of whether the observed frequency of large shocks experienced by two or more banks simultaneously is consistent with the assumption of a multivariate normal or a student *t* distribution under different assumptions about kurtosis. They then go on to propose a simple non-parametric measure that, under fairly non-restrictive assumptions, is able to identify contagion from one bank to another. They use this methodology to identify banks in the EU that are “systemically important” both within countries and across countries. For most of the countries in their sample the authors find what appear to be sensible results. Italy and Spain are exceptions. For both, the measure that the authors use identifies an unreasonable number of very small banks as being systemically important. A possible reason for this findings, the authors argue, is that small banks in these two countries may have a particularly low probability of experiencing an idiosyncratic shock the result of which may be an overstatement of the degree of contagion between these banks and other banks. Overall, the paper points to tight links among banks within countries, as well as links connecting the major banking systems in Europe. The authors find no evidence, however, of a major difference between the strength of links among euro area and non-euro area countries.

Sander and Kleimeier’s study has as its announced goal “unifying the empirical research on interest-rate pass through in the euro zone.” Their central focus is on the interest-rate channel of monetary transmission. After endogenously determining structural breaks for the 1993-2002 period, the authors select optimal pass-through models that allow the pass-through process to be characterized by non-linearities involving both threshold effects and asymmetries. They then apply these models to the market interest rates that in the first instance are the focus of monetary policy as well as to interest-rate proxies for the costs of funds in the markets for various banking services. The results they report thus have implications for both the monetary policy transmission mechanism and degree of competition within and integration of European retail banking markets. The authors find substantial structural changes in the pass-through mechanism over time, but in general these changes are confined to the monetary-policy, as opposed to cost-of-funds, pass-through. These structural changes, moreover, generally antedate the initial moves to the single currency in January 1999 and so cannot be attributed to that *move per se*. The results show further, that despite the structural changes over the

period, considerable heterogeneity in the pass-through mechanisms in the various countries of the euro zone still exists. This heterogeneity, moreover, appears to be due to differences both in macroeconomic factors and institutional factors in these countries. The authors conclude that “neither structural convergence of financial systems . . . nor the single monetary policy can be expected to fully homogenize the euro-zone pass-through in the near future.”

4. Financial stability and capital regulation

Lindquist in “Banks’ Buffer Capital: How Important Is Risk?” examines the influence of type of legislation and, in particular how risk sensitive regulation would influence banks. Mayes in “Who Pays For Bank Insolvency?” examines the handling of the insolvency of large international banks in the smaller European countries.

Lindquist, using bank-level panel data from Norway, tests several important hypotheses concerning the determination of buffer capital. The specific focus of the paper is on the importance of risk, the buffer as insurance, the competition effect, supervisory discipline, and economic growth. A negative or non-significant risk effect is found, which suggests that introducing a more risk-sensitive capital regulation is likely to affect Norwegian banks. Support is also found for the hypothesis that buffer capital serves as an insurance against failure to meet the capital requirements. This article estimates the model separately on two sub-groups of the banks, savings banks and commercial banks. The motivation for this split is that they probably behave differently, and the level of the buffer capital is in general much higher for savings banks than for commercial banks. Although interesting similarities are observed, there are important differences with respect to the behavior of the buffer capital across the two groups of banks. The results for savings banks suggest that there is a negative relationship between their buffer capital and risk. For commercial banks, the results are less clear-cut and robust, which is probably due to the much smaller cross-sectional dimension of this sub-sample.

Mayes discusses the proposals put forward in Mayes et al. (2001) for the handling of bank failures in a manner that is rapid enough to allow the business to continue, respects the ranking of claims on the bank, makes none of the parties worse off than they would have been under a traditional insolvency and, perhaps most important, does not require the use of taxpayer funds, except to guarantee the new organization until it can become adequately capitalized from normal private sector sources. While of general applicability, the paper is particularly concerned with the effective handling of the insolvency of large international banks in the smaller European countries. It deals with three main issues: the relationship between the regime for bank exit and the rest of the framework for the regulation and supervision; the role of market discipline in enabling solutions before the point of insolvency is reached; and the problems in assessing the costs of different exit regimes and public intervention. The article argues that there is a tendency to overestimate

the costs from not using public money and to underestimate the risks posed from a generalized expectation of a bailout.

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