Does Foreign Bank Entry Affect Monetary Policy Effectiveness?: Exploring the Interest Rate Pass-Through Channel

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Abstract

Foreign bank penetration in emerging and developing economies (EMDEs) across the world has been growing in importance since the 1990s. The average share of foreign bank assets in the total banking system of all EMDEs across the world doubled from about 22 to 44 percent between 1995 and 2009. With this rise, there has also been a growing literature on the various monetary and financial implications of foreign bank entry in these economies. One such important issue pertains to the lending behaviour of foreign banks in response to domestic monetary policy shocks and how they specifically affect the monetary policy transmission in a country. For EMDEs with relatively underdeveloped financial markets, the interest rate channel of transmission – which affects aggregate demand through its impact on the costs of loanable funds -- remains an important channel. While a number of papers estimate the degree and pace of interest rate pass-through for various countries, there is almost no study that examines how interest rate transmission changes with higher foreign bank participation, especially in EMDEs. This paper explores the impact of foreign bank entry on interest rate pass-through from policy to lending rates for a panel of 57 EMDEs over the period 1995-2009. The paper also specifically tests for possible identifiable thresholds in terms of foreign bank presence that differentially impact interest rate pass-through. To preview the main conclusions, empirical results suggest that foreign banks tend to enhance interest-rate pass-through in high-threshold countries with average foreign bank assets greater than 35 percent, compared to those with limited entry. The paper also finds that when foreign bank entry results in greater banking concentration it significantly lowers the extent of interest rate transmission.

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