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Foreign Banks, Financial Development, and Economic Growth

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Can foreign banks play an important role in the economic growth of developing countries? This question asks two things: Does a country's level of financial development play an important role in determining the rate of economic growth, and does liberalizing restrictions on the ability of foreign banks to enter and function in a country importantly bolster financial development? I examine each of these questions below.

The first part of this chapter presents conceptual arguments and empirical evidence showing that financial development significantly influences economic growth. The financial system provides "real" services to the economy that are crucial for economic activity and long-run growth. Specifically, the financial system facilitates transactions, eases risk management, mobilizes saving, allocates savings, and monitors the behavior of managers after funding projects. These five financial services provide a rough definition of financial development. Financial systems that are better at providing these services are better developed financially. The conceptual section of this chapter

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predicts that the level of financial development will affect growth by altering the economy's saving rate and by influencing the efficiency with which economies allocate resources; countries with better developed financial systems should grow faster than countries with less well developed systems, holding everything else equal. The empirical evidence confirms this prediction: in a broad cross-section of developing countries over the past thirty years, various measures of financial development predict future rates of economic growth even after controlling for many other economic and political factors. Thus, policies that support financial development, *ceteris paribus*, will accelerate economic growth.

The chapter next examines the role of foreign banks in promoting financial development in developing countries.[1] It discusses potential benefits and costs to financial development from liberalizing foreign bank entry. Because of data limitations, I cannot use rigorous statistical analyses to assess the importance of foreign banks in promoting financial development. Instead, I use evidence from individual country experiences and the conceptual framework developed by Lawrence White, in chapter 1 of this volume.

I argue that foreign banks will promote financial development directly by providing high-quality banking services and indirectly as well, by three means. First, they can spur domestic banks to improve quality and cut costs; second, they can encourage the upgrading of accounting, auditing, and rating institutions; and third, they can intensify pressures on governments to enhance the legal, regulatory, and supervisory systems underlying financial activities.[2] Importantly, easing entry restrictions on foreign banks is likely to create domestic pressures in developing countries to harmonize bank regulatory and supervisory procedures and standards with those of developed countries.

In contrast to these tangible benefits, most of the concerns voiced about easing restrictions on the entry of foreign banks into develop-

1. On the role of foreign banks, this chapter has benefited from many previous studies. In addition to citations in the text, the chapter incorporates the insights of Aliber (1984), Dermine (1993), Goldberg and Saunders (1981), Gray and Gray (1981), Grosse and Goldberg (1991), Hultman and McGee (1989), Sabi (1988), Treasury (1990), Ursacki and Vertinsky (1992), Walter (1981, 1985, 1988), and Walter and Gray (1983).

2. Some analysts contend that foreign banks promote capital inflows and these increased capital inflows stimulate economic growth in developing countries. I remain unconvinced by this argument because (a) capital accumulation does not account for the majority of economic growth and (b) historically, capital has not flowed rapidly from rich to poor countries.

ing countries are typically unsubstantiated or not directly linked to foreign bank entry. Various analysts express fears about foreign banks, ranging from concerns that they will service only select segments of the market to concerns that foreign banks will dominate the entire market. In the vast majority of developing countries, foreign banks account for less than 10 percent of total domestic assets. Thus, entry restrictions could be marginally liberalized without fear of market domination by foreign banks. At the other end of the spectrum, individual foreign banks enter countries by targeting specific market niches. These strategies, however, differ across banks, and these business tactics represent the natural market mechanism through which competitive forces operate to improve financial services. Furthermore, I disagree with the assertion that foreign banks significantly foster capital flight. Capital flight is caused by an unattractive investment climate typically produced by poor policies. Restrictions on capital outflows typically do not impede it. Foreign banks play, at most, a peripheral role in capital flight. Thus, I interpret existing evidence as suggesting that most of the major concerns about foreign banks rest on shaky foundations.

Foreign banks are unlikely to be the engines of growth in any developing country. Even in the same country, regional banks often have important advantages in terms of knowing local customers.[3] Thus, foreign banks are unlikely to play a dominant role in most countries because of cost advantages enjoyed by domestic banks in terms of acquiring information about firms, business conditions, and policy changes. Nevertheless, foreign banks can play an influential role in stimulating financial development and thereby spurring economic growth. Given the very low levels of foreign bank participation in developing country markets, our analysis suggests that most developing countries could benefit from liberalizing foreign bank entry restrictions. As long as an adequate supervisory and regulatory system is in place to ensure the safety, soundness, and transparency of the financial system, most of the potential costs of foreign banks can be circumvented while still enjoying the benefits. Indeed, liberalizing

3. For example, while some northern-based Italian banks operate in southern Italy and southern-based Italian banks compete for business in the north, there is an important regional concentration of business: northern-based Italian banks focus on providing banking services to firms and individuals that reside in the north (see Faini, Galli, and Giannini 1993). This is also true for Spain and many other countries (see Cuadrado, Dehesa, and Precedo 1993).

foreign bank entry restrictions may create powerful pressures to improve bank supervision and regulation.[4]

Does Finance Matter?

This section addresses the question of whether the functions performed by the financial system are important for economic development. I tackle this question conceptually and empirically. Conceptually, I review ways in which the services provided by the financial system may affect economic growth. Specifically, I outline five functions performed by the financial system and explain how these functions affect economic activity. Those countries with financial systems that are better at performing these five financial services will be more economically developed and grow at a faster pace than those with less developed financial systems. The second part of this section presents empirical evidence that confirms these predictions. Countries with larger financial sectors relative to GDP and countries where banks play a larger role relative to the central bank in allocating credit have higher levels of real per capita income and grow faster.

Theory. The financial system provides five services that are important for economic growth. These services may affect growth through two channels: either by increasing the rate of physical capital accumulation or by improving the efficiency with which economies combine capital and labor in production. If the financial system stimulates capital formation and enhances economic efficiency, foreign banks may then have an important role in economic development; foreign banks that improve the provision of growth-enhancing financial services will promote economic development.

Before describing the details, four preliminary points help clarify our conceptual approach to evaluating whether finance is significant for economic development. First, our analysis focuses on specific financial services rather than on particular financial institutions. I find this helpful conceptually because these services are the same across countries and through time, while the institutions that perform these functions differ across countries and change over time within the same country. Of course the quantity, quality, and availability of

4. For specifics on regulatory and supervisory issues with foreign banks, see Campbell Report (1983), Dale (1984), Key (1992), Musalem et al. (1993), and Treasury (1990).

these services differ markedly across countries.[5] Second, financial services can affect growth both by increasing the national saving rate and by improving the efficiency with which society allocates capital. Although the field of development economics has focused on the role of physical capital in economic development, our conceptual framework suggests that financial development will importantly affect economic growth by improving the efficiency with which society allocates capital. Third, I focus exclusively on how the financial system influences economic growth even though we recognize that economic development may affect the financial system. I examine only one direction of causality because this chapter is primarily concerned with the role of foreign banks in spurring financial and thereby economic development. Fourth, in reviewing and studying financial services, our conceptual approach gives a rough definition of financial development. Financial systems that provide higher quality financial services are more highly developed financially than financial systems that provide these services less well.

Channels. In 1954, Arthur Lewis, one of the pioneers of development economics, argued that "the central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 or 5 percent of its national income or less, converts itself into an economy where voluntary saving is running at about 12 to 15 percent of national income or more" (Lewis 1954, 155). Similarly, W. W. Rostow (1960, 8) asserted that a large jump in the saving rate is necessary, though not sufficient, for rapid economic advancement. This "capital fundamentalist" view—that rapid physical capital accumulation is the central factor underlying rapid economic development—has been a dominant and continuing feature of development economics. An important corollary of this view is that international capital inflows can importantly contribute to economic growth by increasing domestic capital accumulation. Thus, capital fundamentalism suggests that foreign banks can increase economic growth by raising the domestic saving rate or by increasing capital inflows.

As Arthur Lewis was enumerating the central role of capital in economic growth, Robert Solow (1957) found that a surprisingly small fraction of the differences in both the level of economic development and the rate of economic growth across industrialized countries is explained by physical capital. Denison (1967) similarly argued that

5. In the empirical section, we must use measures of financial institutions because it is very difficult to measure the provision and quality of financial services directly.

less than a third of the differences in income per capita or the rate of economic growth is explained by physical capital. These findings suggested that some countries were better at combining capital and labor than other countries.[6] As Paul Krugman (1993, 13) noted, "poorer countries simply have worse production functions, and hence the marginal product of capital is not in fact as high as their low capital-labor ratios would suggest." Thus, many analysts reject capital fundamentalism and argue that improvements in productivity and economic efficiency are at least as important as physical capital accumulation in explaining economic development. Thus, financial development, and therefore foreign banks, will have to improve economic efficiency to promote growth according to this productivity view of development.

In sum, there are two major channels through which financial systems may affect growth. They may alter the rate of physical capital accumulation, or they may alter the productivity and efficiency with which capital and labor are combined to produce goods and services.

Financial services. Though differing widely in quality, all financial systems provide five basic financial services that affect long-term economic development through the capital accumulation channel or the productivity channel.[7] The basic theme of this section is that these financial services constitute real value added; financial institutions are not simple balance sheets, and financial markets are not simple veils for the functioning of the real sector. The financial system provides real services that are crucial for economic activity and long-run growth. These financial services influence growth both by influencing capital accumulation and by affecting economic efficiency. Our analysis predicts, therefore, that those financial systems that are better at providing these services will provide a correspondingly greater boost to economic growth.

Financial systems facilitate trade. At the most rudimentary level, money minimizes the need for barter and thereby encourages commerce and specialization. As argued by Adam Smith over two hundred years ago, specialization in production forms the foundation of modern economies and stimulates productivity improvements. At a more sophisticated level, checks, credit cards, and the entire payment-and-clearance system simplify a wide array of economic interactions. In most industrialized economies, individuals and businesses

6. For recent growth accounting work on developing countries see King and Levine (1994).

7. This section draws on Merton (1992) and Levine (1996).

take the ability to write and settle financial transactions easily for granted. The absence of a reliable means for conducting trade, however, importantly impedes economic activity and economic growth. This is exemplified most notably in transitional socialist economies where insufficiently developed payment-and-clearance systems have stymied economic interactions. Thus, financial systems that make trade and commerce easy foster economic activity and promote economic growth by encouraging and supporting a more efficient allocation of resources.

Financial systems facilitate risk management. Financial systems price risk and provide mechanisms for pooling, ameliorating, and trading risk. Recent uses of options and futures contracts to hedge and trade interest-rate and exchange-rate risk have been well publicized. At a more basic level, financial institutions transform asset and liability maturities to satisfy savers and investors. The securities most useful to businesses—equities, bonds, bills of exchange—may not have the liquidity, security, and risk characteristics that savers desire. By offering attractive financial instruments to savers—liquid demand deposits, well-diversified mutual fund portfolios—financial intermediaries can tailor financial instruments for different clients and thereby manage risk for individuals. By facilitating the management, trading, and pooling of risk, financial systems can ease the interactions between savers and investors. Financial systems that are better at providing risk-management services will encourage efficient resource allocation and may also stimulate saving and investment (Levine 1991).

One particularly important type of risk is liquidity risk. Liquidity risk arises because savers frequently need quick access to their savings, yet their assets may be difficult to sell. Liquidity risk is important for long-run growth because big investments often enjoy economies of scale, promote specialization, and stimulate technological innovation, but big investments require a long-run commitment of capital. Since investors are reluctant to relinquish control of their savings for long periods, banks—and other financial arrangements—may arise to reduce liquidity risk on the part of savers while providing firms with long-term capital. As shown by Bencivenga and Smith (1991), well-functioning banks facilitate long-run investments. Making long-run, illiquid investments easier may in turn spur investment, improve resource allocation, and stimulate economic growth.

Financial systems mobilize resources. Financial intermediaries mobilize resources from disparate savers to investment in worthwhile investment projects. Some worthwhile investment projects may require large capital inputs, and some projects enjoy economies of scale. By

agglomerating savings, financial intermediaries enlarge the set of feasible investment projects and thereby encourage economic efficiency. Thus, efficiency and savings may be importantly linked; by facilitating resource mobilization, financial intermediaries increase the feasibility of large, high-return investment projects. As noted by Greenwood and Smith (1994), Bagehot (1873, 3–4) argued that the role of the financial system in mobilizing resources is crucial for economic development.

> We have entirely lost the idea that any undertaking likely to pay, and seen to be likely, can perish for want of money; yet no idea was more familiar to our ancestors, or is more common in most countries. A citizen of Long in Queen Elizabeth's time . . . would have thought that it was no use inventing railways (if he could have understood what a railway meant), for you would have not been able to collect the capital with which to make them. At this moment, in colonies and all rude countries, there is no large sum of transferable money; there is not fund from which you can borrow, and out of which you can make immense works.

Thus, by effectively mobilizing resources for sound investment projects, the financial system may play a crucial role in permitting the adoption of better technologies and thereby encouraging economic development.

Financial systems obtain information, evaluate firms, and allocate capital. Firms, projects, and managers are difficult to evaluate. Individual savers may not have the time, resources, or means to collect and process information on a wide array of enterprises, markets, managers, and economic conditions. Financial intermediaries may have a cost advantage in obtaining and evaluating information and then allocating capital based on these assessments. Since many firms and entrepreneurs will solicit capital, financial intermediaries that are better at selecting the most promising firms and managers will spur economic growth by fostering a more efficient allocation of capital. The higher returns to capital investment produced by financial intermediaries that better evaluate firms and allocate capital may also increase savings and capital formation, further boosting economic growth.

Financial systems provide corporate governance. Small individual investors often find it arduous, time-consuming, and costly to evaluate and monitor the performance of firm managers. Consequently, financial intermediaries are often charged with compelling managers to act in the best interests of firm claim holders (stock, debt, and loan

holders). That is, financial intermediaries help resolve the principal-agent problem by facilitating the ability of claim holders to oversee the actions of managers (agents). Financial systems that are more effective at mitigating the principal-agent problem will prompt managers to allocate resources more efficiently.

Summary. Theory predicts that the services provided by financial systems are crucial for economic development. The links between financial and economic development may be complex. For example, financial services may affect growth by increasing the rate of capital accumulation or by influencing the efficiency with which economies combine labor and capital in production. Further, across countries, different combinations of financial institutions, markets, and instruments provide services. Moreover, international financial systems provide very different quality financial services.

Nonetheless, the analysis suggests that the five financial services—facilitating transactions, easing risk management, mobilizing saving, allocating funds, and monitoring firm managers—are crucial determinants of economic growth. This argument conforms with Hicks's (1969) view that the industrial revolution in England required, as a precondition, the financial revolution that dramatically increased the availability of financial services. According to Hicks, the ability both to mobilize resources for permanent investment in capital goods and to provide liquid assets to savers was necessary for the massive investment and technological change that characterized the industrial revolution.[8] Thus, the basic prediction that emerges is that countries with better developed financial systems—countries that provide higher-quality financial services—should enjoy faster rates of economic growth, *ceteris paribus*, than countries with less well developed financial systems. Developing countries that encourage financial development enhance their chances of achieving long-run sustained growth. In the following section I will evaluate this prediction empirically.

Evidence. In a series of articles, King and Levine (1993a,b,c) study the link between financial development and economic growth. Using data on eighty countries over the 1960–1989 period, they show that various measures of the level of financial development are strongly associated with real per capita GDP growth, the rate of physical capital accumulation, and improvements in the efficiency with which economies employ physical capital. Moreover, King and Levine show

8. I learned about the views of Hicks (1969) through Bencivenga, Smith, and Starr (1995).

that the level of financial development predicts future economic growth even after controlling for other economic and political factors. These results contrast sharply with the weak links between growth and a wide array of other economic indicators, as shown by Levine and Renelt (1992) and Levine and Zervos (1993). In contrast to King and Levine (1993a,b,c), this chapter focuses on non-OECD countries.

We use two measures of financial development. The first is called DEPTH and equals the ratio of liquid liabilities of the financial system divided by GDP. Liquid liabilities consist of currency held outside the banking system plus demand and interest-bearing liabilities of banks and other financial institutions. DEPTH is the traditional measure of financial development and is designed to measure the size of the formal financial intermediary sector relative to economic activity (see McKinnon 1973 and Goldsmith 1969).

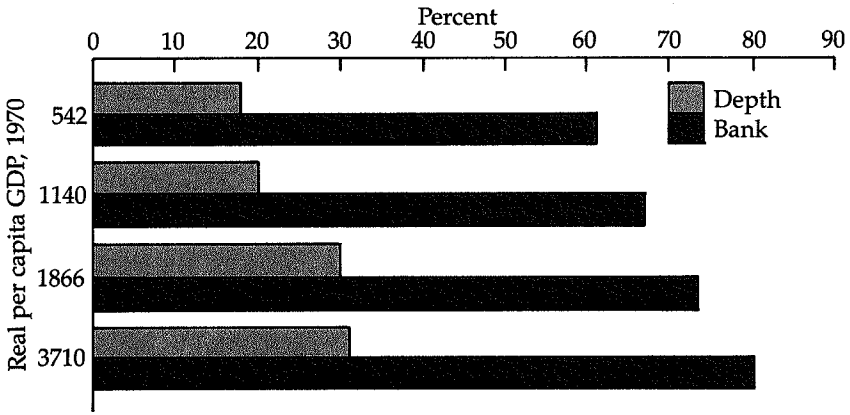
The second indicator seeks to measure the relative importance of specific financial intermediaries. For the 1960–1989 period, the only decomposition is between the central bank and deposit banks. Thus, I compute the ratio of deposit-bank domestic credit divided by deposit-bank domestic credit plus central-bank domestic credit and call this measure of financial development BANK. Banks are more likely to provide the financial services detailed above than is the central bank. Thus, higher levels of BANK should be associated with a greater provision of financial services and greater financial development.

These measures may not accurately capture the provision of growth-promoting financial services as defined above. DEPTH may not be closely related to risk management and information processing, for example. BANK does not measure the provision of financial services by nonbanks, and governments may control banks as tightly as they control central banks. Nonetheless, these different measures tell similar stories about the relationship between financial development and economic activity.

Figure 6–1 shows that the level of financial development in 1970 is closely associated with the level of real per capita GDP in 1970 for a sample of fifty-six developing countries. I rank countries by real per capita income in 1970 and break the countries into four groups with the same number of countries in each group. The poorest group of countries had a real per capita GDP of $543 (in $1987) in 1970, and the richest group of developing countries had a real per capita income of $3,710.[9] As illustrated, richer countries had higher DEPTH and BANK. Countries with larger formal financial systems and countries

9. These figures are from Summers and Heston (1988).

FIGURE 6–1: REAL PER CAPITA INCOME AND FINANCIAL DEVELOPMENT FOR SELECTED DEVELOPING COUNTRIES, 1970



Observations per quartile = 14
Depth: liquid liabilities divided by GDP
Bank: deposit bank domestic credit divided by deposit bank domestic credit plus central bank domestic credit

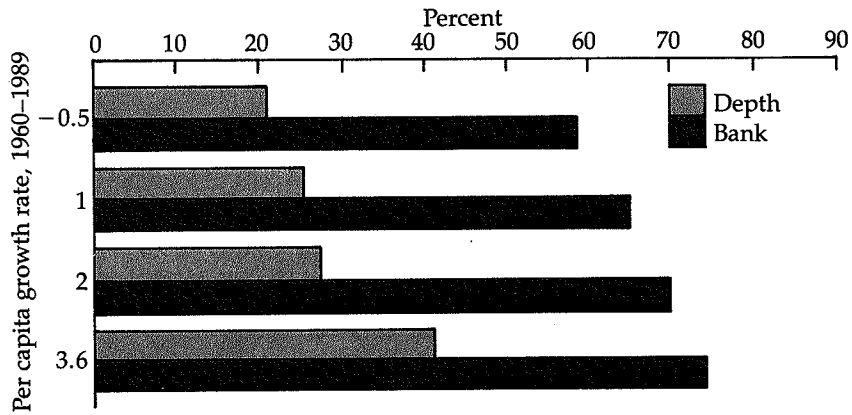
SOURCE: Author.

with larger deposit banks relative to the central bank in terms of allocating credit tended to be richer.

Figure 6–2 relates the average level of financial development over the 1960–1989 period to the average real per capita growth rate over this same period. Again, we see a close link between financial development and economic growth. Countries with better developed financial systems grew faster. These results hold even when controlling for many other economic and political factors.

Finally, figure 6–3 examines the relationship between the level of financial development in 1960 and economic growth over the next thirty years. Since I could not compute the value of BANK for many countries in 1960, I conduct this analysis only with DEPTH. Here, I am trying to abstract from the possibility that the strong association between financial development and economic activity occurs because economic activity spurs financial development. As depicted in figure 6–3, however, DEPTH in 1960 strongly predicts future economic growth. Importantly, these results hold when controlling for other factors, and these results do not hold in reverse; the level of real per capita income in 1960 does not predict improvements in DEPTH over the next thirty years. Thus, the data are consistent with the view

FIGURE 6–2: GROWTH AND FINANCIAL DEVELOPMENT FOR SELECTED DEVELOPING COUNTRIES, 1960–1989



Observations per quartile = 15
Growth: per capita GDP growth
Depth: liquid liabilities divided by GDP
Bank: deposit bank domestic credit divided by bank credit plus central bank credit

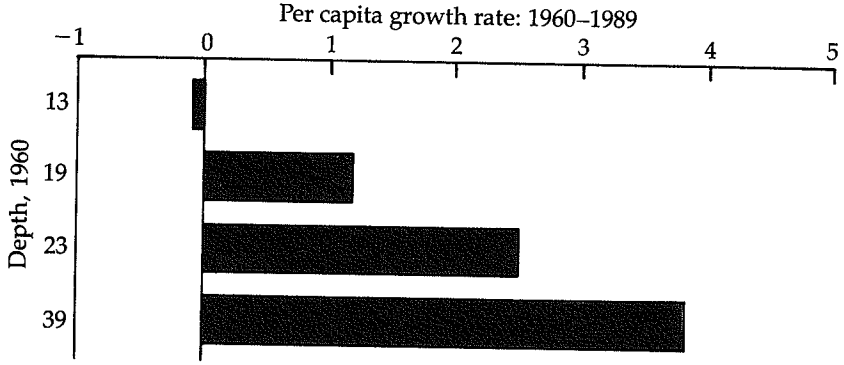
SOURCE: Author.

that financial development stimulates economic growth. Policies that promote financial development, *ceteris paribus*, will stimulate economic development. Easing restrictions on foreign bank entry is one policy that can help spur financial development in many developing countries.

What Role for Foreign Banks?

Given that financial development plays an important role in promoting economic growth, this section examines the role that foreign banks can play in stimulating financial development and thereby spurring growth in developing countries. I could not construct a cross-country data set with measures of foreign banks across a sufficient number of countries to quantify the importance of foreign banks in promoting financial and economic development in a rigorous, statistical manner. Instead, this section sheds some light on the role that foreign banks play in financial and economic development based on individual country experiences. First, I discuss potential benefits from permitting foreign bank entry. Second, I consider potential costs from

FIGURE 6–3: INITIAL DEPTH OF FINANCIAL DEVLEOPMENT, 1960, VERSUS FUTURE GROWTH, 1960–1989, FOR SELECTED COUNTRIES



Number of observations in each quartile = 11
Growth: per capita GDP growth, 1960–1989
Depth: liquid liabilities divided by GDP, 1960

SOURCE: Author.

liberalizing foreign bank entry. I review the case of Australia in some detail using Catherine McFadden's (1994) study. The experience of Australia highlights, first, strategies that particular foreign banks employed when entering the Australian market and a preliminary assessment of the results of those strategies, and second, the effect on the Australian financial system.

I find that while openness to foreign banks will probably not ignite rapid economic development, the benefits of liberalizing entry restrictions on foreign banks seem in most cases to be much larger than the costs. The major concerns about foreign bank entry are often only peripherally related to foreign banks, and in most cases these concerns can be allayed while still obtaining the benefits of foreign banks.

Benefits. Liberalizing entry of foreign banks may have important benefits for at least three related reasons. First, reducing impediments to foreign bank entry may improve access to international capital markets. Second, easing restrictions on foreign bank entry should improve the quality and availability of the five financial services noted above by stimulating competition in and contestability of domestic financial markets and by facilitating the application of more modern banking skills, management, and technology in the domestic market. Third, openness to foreign banks may stimulate improvements in

both domestic financial policy and the financial infrastructure, which in turn will promote domestic financial development (Glaessner and Oks 1994). The financial infrastructure includes the legal system underlying financial transactions and the supervisory and regulatory system. Improvements in the financial infrastructure will facilitate the provision of financial services and make the financial system more stable. This section reviews each of these arguments and presents some evidence regarding their validity and significance.

International capital flows. In line with the capital fundamentalist approach to economic development, countries may ease restrictions on foreign bank entry as a means of encouraging capital inflows in the belief that these capital inflows will promote capital formation and economic growth. For example, Korea (Euh and Baker 1990) and Australia (Campbell Report 1983) specifically emphasized that one of the policy objectives sought in opening to foreign banks was to enhance contacts with the international financial community and thereby to increase capital inflows.[10] The efficacy of this strategy relies on two premises: first, foreign banks will facilitate capital inflows; second, capital inflows will spur economic development. I examine each of these premises.

Bhattacharaya (1993) reports individual cases in Pakistan, Turkey, and Korea, where domestically based and capitalized foreign banks helped to make foreign capital accessible to fund domestic projects. Pigott (1986) finds in a review of Pacific-Basin countries that while foreign banks rely more than domestic banks on foreign borrowing, foreign-owned banks still fund three-fourths of their domestic loans from domestic sources. Unfortunately, most of the evidence on the role of foreign banks in providing greater access to international capital markets is scant, scattered, and unsystematic. Thus, it is difficult to assess the role of foreign banks in promoting access to international capital markets.

We now turn to the second premise of the belief that foreign banks promote economic development by encouraging capital inflows. This development strategy presupposes that capital inflows are important to economic growth. There are good reasons to believe, however, that international capital flows will not play an important

10. As McFadden (1993, 10–11) notes, "The Australian Industries Development Association, a powerful lobby representing manufacturing, mining, and mineral processing interests, advocated foreign bank entry to develop Australian capital markets and the real economy. . . . Foreign banks were expected to bring new capital from establishing (subsidiary) operations, through access to parent capital and from international markets."

role in fostering growth in developing countries. As noted above, considerable empirical evidence suggests that the impact of capital accumulation on economic growth is surprisingly weak. Furthermore, history suggests that not much capital flows from rich to poor countries. For example, the pre–World War I period witnessed much larger capital flows relative to income than did the post–World War I period. Yet very little of this capital flowed from rich to poor countries. As documented by Nurske (1954) and Feis (1964), capital flowed from Europe to already high-income countries like Canada, New Zealand, Australia, Argentina, and the United States, where per capita incomes were as high or higher than in Britain. Little capital flowed to poor colonies such as India. More recently, the period from 1972 to 1981 is often viewed as a period of large capital flows. Yet less than 15 percent of domestic investment was financed by foreign borrowing, even in highly indebted countries, during this period. More important, these capital flows did not produce a sustained boom in economic development. Finally, it is worth considering the case of southern Italy. Faini et al. (1993) show that despite openness to banks from northern Italy and despite large capital inflows, southern Italy has not matched the performance of northern Italy over the past half century.

International capital flows are not likely to be a major engine of economic growth in developing countries. As Paul Krugman (1993, 22) argues,

> There is nothing in past historical experience to suggest that developing countries will be the recipients of large capital flows; there is no convincing evidence that rather low neoclassical estimates of the impact of capital on growth are wrong.

Thus, easing entry restrictions on foreign banks may have its greatest growth-promoting effects through channels other than stimulating international capital inflows.

Better domestic financial services. Easing restrictions on foreign bank entry should improve the quality, pricing, and availability of the five financial services to domestic firms and individuals. Foreign banks will directly bring new and better skills, management techniques, training procedures, technology, and products to the domestic market. In addition, foreign banks will indirectly force improvements in the domestic financial system by pressuring existing institutions to improve. Specifically, foreign banks will stimulate competition in and contestability of domestic financial markets, which will put downward pressure on the price of financial services and

TABLE 6–1
BANK OPERATING RATIOS, INDUSTRIAL COUNTRIES, 1977

	Open[a]	*Closed*[b]
Gross earnings margin to volume of business	3.21	4.48
Pretax profits to volume of business	0.58	0.78
Operating costs to volume of business	2.27	3.25

NOTE: Data are for 1977. Countries include Austria, Belgium, France, Italy, Netherlands, Switzerland, and United States under "*Open*." Countries include Australia, Canada, Finland, Norway, Spain, and Sweden under "*Closed*." Gross earnings = gross interest minus gross interest paid plus other (net) income. Volume of business refers to total assets.
a. Open: Banks in countries excluding foreign bank entry.
b. Closed: Banks in countries permitting foreign bank entry.
SOURCE: Terrell (1986).

spur existing financial institutions to improve the quality of their services to stay in business.

In terms of specifically linking foreign banks to the five financial services discussed above, foreign banks may

- stimulate improvements in transaction services by introducing credit cards or improving the payments system
- introduce, expand the availability of, and lower the cost of risk management mechanisms
- intensify credit assessment procedures and enhance information gathering techniques
- introduce improved mechanisms for monitoring firm and manager performance
- intensify the competition of mobilizing domestic resources that would expand the mobilization of domestic saving and promote better resource allocation

Thus, by intensifying competition and by directly bringing new services to bear on the domestic market, foreign banks may provoke rapid improvements in the provision of growth-promoting financial services.

There is some evidence that openness to foreign banks goes hand-in-hand with greater banking efficiency. Table 6–1 is taken from Terrell (1986) and shows that countries that permitted foreign bank entry had lower profits and were more efficient than countries that had more restrictive policies. Similarly, as Indonesia reduced restrictions on foreign bank activities in its domestic market and thereby intensified competition with domestic banks, the percentage differ-

ence between interest rates charged by domestic and foreign banks fell dramatically, as shown in table 6–2. Similarly, as noted by Bhattacharaya (1993), enhanced foreign bank competition has forced lower commission fees in Turkey; fees on letters of credit fell from 1.5 percent to 0.5 percent, and fees on letters of guarantee fell from 4 percent to 1 percent. In Australia, foreign bank competition helped pull down interest rate spreads. Whereas major corporations borrowed at 75 to 100 basis points above the Australian Treasury Bill rate before foreign bank entry liberalization, major corporations borrow at between 25 and 50 basis points above the bill rate now, as reported in McFadden (1993, 46–47).

In addition to lowering the cost of banking services, foreign banks have also introduced new and better services. For example, in Spain, Midland Bank pioneered the commercial paper market, while First Chicago introduced swaps (see Bhattacharaya 1993, 23). Furthermore, foreign banks have led the boom in credit cards and automated teller machines (ATMs) in Spain. In Turkey, foreign banks computerized most of their banking operations, used modern budgeting and planning techniques, and quickly tied themselves to the SWIFT payments system network. To remain competitive, domestic banks soon followed to remain competitive. Interestingly, although 10 percent of the employees in Turkey's banking sector had university degrees in 1980, after permitting greater foreign bank access, the figure rose to 20 percent by 1990.[11] Thus, evidence suggests that foreign banks directly improve the range and quality of financial services in countries that open to foreign banks and indirectly promote financial development by inducing domestic banks to improve their operations.

Finally, while difficult to establish unambiguously, as foreign banks enter a country, they may improve ancillary institutions and procedures that promote the flow of information about firms. As foreign intermediaries undertake brokerage and underwriting activities, they will encourage information acquisition. In addition, foreign banks may encourage the emergence of better rating agencies, accounting and auditing firms, and credit bureaus that acquire and process high-quality information on individuals, firms, and financial institutions. Similarly, these banks may improve information disclosure about banks themselves in order to attract customers by demonstrating their sound financial condition. Thus, as part of increasing competition, foreign banks may create pressures that improve the quality and availability of information about individuals, firms, and financial intermediaries.

11. See Bhattacharaya (1993).

TABLE 6–2

SELECTED DEPOSIT RATES OF FOREIGN AND DOMESTIC BANKS IN INDONESIA, 1978–1985

	1978	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*
Six-month deposit rate								
Private national banks	15.7	16.8	18.2	18.1	18.4	18.8	20.7	17.8
Foreign banks	8.4	9.8	8.7	10.2	14.3	17.0	21.4	17.0
Twelve-month deposit rate								
Private national banks	17.9	18.1	20.0	19.4	19.4	19.7	20.5	19.8
Foreign banks	10.0	9.7	12.1	11.9	15.5	17.0	19.1	16.6
Inflation % (consumer prices)	8.1	22.0	18.4	12.2	9.5	11.8	10.4	4.7

SOURCE: Cho and Khatkhate (1989), 186–87.

Financial regulation. The ease and effectiveness of financial arrangements depend importantly on the legal code governing property rights, the legal system's ability to enforce those property rights, the legal and regulatory requirements regarding information disclosure, the transparency and availability of financial statements on firms and financial intermediaries, and the supervisory and regulatory systems overseeing the financial system. When property rights are well defined and enforced, when information on firms and financial institutions is accurate, easy to obtain, and easy to understand, and when the supervisory and regulatory systems foster stability, innovation, and fairness, the financial system will provide better financial services than when these conditions are not met. As argued by Glaessner and Oks (1994), opening to foreign banks may spur improvements in the financial infrastructure and thereby promote the development of the domestic financial system. White (1995) provides a detailed assessment of when harmonization of particular regulations between countries will be optimal and when competition between regulators in different countries will lead to the best set of regulations for promoting financial development.

A developing-country perspective on regulatory harmonization. Consider the case of a small developing country that eases restrictions on foreign bank entry by developed-country banks. The developing country may also seek access to developed-country markets for its banks. In this situation, the burden of regulatory change will likely fall on the developing country. Before granting access to developing-country banks, the developed country will require evidence that the developing-country authorities "appropriately" supervise and regulate their banks. And the developed country will use its own supervisory and regulatory system to define *appropriate*. Thus, unlike the case where two or more developed economies may face regulatory competition, the burden of changing regulations and supervisory procedures will probably fall on the developing country. Developing countries will have to harmonize.

Interestingly, the pressure for harmonization may come from developing-country banks. Faced with entry and competition by developed-country banks, developing-country banks may seek rapid access to developed markets so that they can provide a competitively complete array of financial services to existing clients. Provision of competitive services may require having a subsidiary in a developed country. But entry into a developed country will require satisfying developed-country requirements about the supervisory and regulatory capacity of the developing country. Under these conditions, domestic banks may pressure domestic regulatory authorities to harmonize their supervisory and regulatory procedures and standards with those of developed countries so that the domestic bank can enter developed markets.

This harmonization will cover different types of regulation. While there may be some harmonization of economic regulations—regulations regarding limits on prices, profits, and entry and exit requirements—there will be two major forms of regulatory harmonization. The first is prudential regulation—regulations on capital, restrictions on the assets and liabilities of banks, deposit insurance, limitations on lending to insiders, and standards of approval of bank management. The second is information regulation—regulations regarding the disclosure of information about bank assets, liabilities, interest rates, fees, losses, owners, capital, related-party transactions, and so forth. To the extent that a developed country has a regulatory regime that fosters greater financial development than the developing-country regulatory regime, this harmonization will be socially beneficial to the developing country. The availability of human capital skills, however, is one important risk faced by many developing countries. Specifically, developed countries may rely on a great deal of technical expertise on the part of regulators and supervisors, which may not be available in developing countries. Thus, supervisory and regulatory regimes may not be immediately "harmonizable" in developing countries.

Consider, for example, the case of Mexico. The recently signed North American Free Trade Agreement (NAFTA) has a financial services component. Under condition-specific conditions specified in NAFTA and discussed in Glaessner and Oks (1994), Mexico will open to United States and Canadian banks, and the United States and Canada will allow Mexican banks to enter their domestic markets. To have access to the United States, Mexican banks must demonstrate to the Federal Reserve that Mexican supervisors can adequately supervise its banks and related financial institutions. Thus, as Mexico has opened its doors to U.S. banks and sought entry for its banks in the United States, there have been pressures to harmonize prudential regulations in areas such as capital adequacy, valuation and accounting principles, related-party transactions, and conflict-of-interest provisions. Furthermore, because of pressures for regulatory harmonization, Glaessner and Oks predict important improvements in Mexico's laws and regulations regarding corporate and bankruptcy law, laws regarding negotiable instruments, the functioning of registries of land, buildings, and goods in warehouses, and laws relating to

secured transactions. NAFTA will prompt improvements in these registries, which should lower the cost of financial intermediation.

Thus, easing foreign-entry restrictions may create incentives that improve domestic bank regulation with at least two beneficial effects on economic development. First, better bank regulation will reduce the chances for systemic bank failures. Second, better bank regulation will improve the sustained provision of growth-enhancing financial services—risk diversification, transaction facilitation, resource mobilization, resource allocation, and corporate governance. Developing-country bank regulation will move toward the developed-country norm, further emphasizing the importance of developed countries' choosing an optimal mix of competition and harmonization in fostering the development of an international regulatory regime for financial services.

Additional regulatory benefits. In addition to the regulatory benefits mentioned above, opening to foreign banks may spur regulatory improvements by removing domestic political impediments to regulatory improvements. For example, in many developing (and developed) countries, regulators may have weak incentives, inadequate staffs, and insufficient resources to acquire comprehensive information about financial groups and to supervise and regulate banks energetically. Gaining the support of bankers may be more important politically than supervising and regulating banks well. This may change with the relaxation of restrictions on foreign bank entry. To expand abroad, domestic banks must convince foreign central banks of the soundness of the domestic supervisory and regulatory system. Thus, relaxation of entry restrictions on foreign banks realigns incentives: now domestic banks and domestic regulators both seek to improve supervision and regulation to internationally accepted standards. This realignment of incentives should work to reduce capture of regulators by banks, to improve the flow and quality of information about banks, to boost the level of public resources devoted to supervision and regulation, and to clarify the goals of the regulatory agency. Thus, opening to foreign bank competition may enhance supervision and regulation by realigning incentives and reducing political impediments to improvements.

Conclusions on benefits from openness to foreign banks. Two broad conclusions emerge from this analysis. First, while openness to foreign banks may promote capital flows, international capital flows in general are unlikely to promote growth significantly in developing countries, so that opening to foreign banks will not significantly enhance economic development by improving access to foreign capital.

Second, foreign banks are likely to promote growth by stimulating improvements in the domestic banking system. Country-specific evidence suggests that openness to foreign banks is positively associated with financial development, and theory plus statistical and historical evidence imply that greater financial development boosts economic growth. These two findings suggest that opening to foreign banks will spur economic growth by encouraging development of the domestic financial system. Nevertheless, countries around the globe impose severe restrictions on foreign bank entry. A thorough understanding of the reasons underlying these restrictions is necessary for evaluating the potential role that foreign banks can play in supporting both financial and economic development.

Concerns about Foreign Bank Entry. Countries have numerous concerns about liberalizing foreign bank entry into their domestic markets. Countries are concerned that foreign bank entry may actually stymie financial development instead of enhancing the provision of financial services and capital. This section analyzes four broad categories of concerns.

International capital outflows. Foreign banks are often accused of stimulating capital flight. Through closer ties to the international financial community than domestic banks, foreign banks may facilitate capital outflows.

Closer scrutiny, however, suggests that this concern rests on shaky foundations. In the case of a country with an open capital account, Musalem et al. (1993, 4) argue that "the role of foreign institutions is little different from that of domestic institutions in countries. Both have the means to facilitate flight if there are strong incentives to do so." If a country has a closed capital account, foreign banks "may facilitate capital flight by providing contacts to their parent institutions in foreign financial centers and by facilitating arrangements for the maintenance of bank accounts and other investments in overseas markets" (Musalem et al., 1993, 4). But capital controls are almost universally ineffective when there are strong incentives for capital to flee whether foreign banks exist or not. Moreover, foreign banks do not cause capital flight; the causes underlying capital flight are poor and inconsistent policies, political uncertainty, and high and variable taxes that make the domestic market an unattractive and risky place to invest (Gordon and Levine 1989). Countries concerned about capital flight should tackle these fundamental determinants of capital flight. Thus fears of capital flight do not seem to justify restrictions on foreign bank entry.

From cream skimming to market dominance. Policy makers often express concern that foreign banks will (a) service only the most profitable market segments; (b) not service the retail market; (c) service only foreign corporations; or (d) dominate the entire domestic market. Market-based business strategy suggests that foreign banks will attempt to carve out areas of competitive advantage. Foreign banks will enter and attempt to develop products and services that they have successfully offered in other countries, and foreign banks will both follow and lead corporations from their base countries that are expanding or contemplating expansion in other countries. Similarly, foreign banks, particularly when entering developing countries, will provide more sophisticated financial services than domestic financial institutions. Thus foreign banks, like any business, may initially attempt to service only particular parts of the market. In addition to concerns that foreign banks will service only small sectors of the financial market, many countries also fear that foreign banks will dominate the entire financial sector; restrictions on foreign banks are sometimes justified on "infant industry" arguments. Thus foreign banks are criticized both for having too narrow a focus and too expansive objectives.

There are extremely few cases in which foreign banks dominate domestic financial markets. Gelb and Sagari (1990) report that foreign banks' median share of total domestic assets in a sample of twenty countries is about 6 percent. Thus in the vast majority of cases, foreign banks constitute a very small share of the domestic credit market. Countries could significantly liberalize foreign bank entry even while placing a cap, of say 40 percent, on the maximum share that foreign banks can have in the domestic market. This might ameliorate fear of domination while still permitting the benefits of foreign banks to flow into the domestic financial system.

The evidence regarding foreign banks' picking market niches is more anecdotal and difficult to interpret. The evidence supports the perspective that foreign banks initially focus on market niches where they expect to have competitive advantages. This is not a surprising or negative implication of foreign bank entry. Businesses attempt to find profitable markets, and this manifestation of market-based competition will promote improvements in the provision of financial services to domestic clients.

McFadden (1994) documents the different strategies employed by particular foreign banks as they entered the Australian market in the 1980s. Appendix 6–A reviews some of McFadden's work. Here it is worth noting that different foreign banks pursued different strategies. Some focused on attracting large Australian corporations, some

focused on servicing corporations from their base countries, some focused on sophisticated financial products, and some focused on the retail market. Furthermore, some foreign banks were successful and some have experienced losses. Moreover, many Australian banks adjusted, upgraded service, and fought off foreign competition. Thus, individual banks pursued strategies based on their strengths, domestic banks often responded successfully, and domestic firms and consumers benefited from the more competitive climate.

Importantly, domestic financial policies can often create profit opportunities for foreign banks. For example, Nag and Shivaswamy (1990) note that 75 percent of foreign bank credit advanced in India went to the growing private industrial sector, while only 30 percent of domestic bank credit went to private industry. The reason underlying this difference is that the government forces domestic banks to lend to public enterprises and agriculture, which are less profitable and have high loan default rates. It is thus not surprising that foreign banks are more profitable in India and avoid lending to risky sectors. Instead of restricting foreign bank entry and stymieing financial development, countries may wish to modify directed credit programs so that domestic banks are not disadvantaged.

Local commitment. A third concern is that foreign banks will quickly retreat when faced with problems in the local market or when faced with problems in their domestic market. Thus foreign banks may enhance the fragility of the domestic financial system if they are a large component of it. Empirical evidence is scant.[12]

Supervision and the payment system. Country officials are often charged with maintaining the safety of the financial system, including the payment system. If foreign banks are permitted direct access to the payment system, then particular care must be taken to maintain a secure and reliable payment system. In the case of Australia, opening to foreign banks accelerated the development of an improved interbank payment system. Similarly, deregulation often accompanies reduced entry restrictions on foreign banks. Countries may need to enhance prudential supervision as they open to foreign banks. As noted above, NAFTA has spurred improvements in Mexico's bank supervision system. Thus, while foreign bank entry should not be allowed to overwhelm the government's ability to regulate, supervise, and support banks, opening to foreign banks may be coordinated

12. Bhattacharaya (1993) shows that foreign banks in the United States have not retreated during recessions. However, Vittas (1995) provides some examples of industrialized-country banks retreating from overseas markets.

with improvements in the financial infrastructure so that domestic companies and individuals can enjoy better financial services.

Final points on concerns with foreign banks. While it is natural and appropriate to be concerned about the entry of foreign banks, these concerns should, in most cases, not prohibit liberalizing entry restrictions on foreign banks. Foreign banks are unlikely to enlarge capital outflows significantly, and countries should avoid capital flight by creating an attractive investment climate, not by restricting foreign bank entry. In most countries, foreign banks play a small role, so that fear of foreign banks dominating the market should not impede easing foreign bank entry restrictions. Although individual foreign banks will attempt to identify profitable niches, these strategies will probably differ across foreign banks, and these strategies represent the natural market process through which competitive forces operate to improve financial services. While foreign banks may have a harder time entering retail markets, this probably results from high information costs, and these natural barriers may fall over time as foreign banks gain familiarity with the local market. Thus, most countries can probably obtain the benefits from foreign banks without incurring the costs, though entry should not run ahead of the ability of domestic regulators and supervisors to ensure a safe and sound financial system.

Conclusion

Using a two-part approach, this chapter has examined the role that foreign banks can play in economic development. In the first part, I presented conceptual arguments and empirical evidence that suggest that a developing country's level of financial development is important for its future rate of economic growth. The financial system provides services to the nonfinancial sector that help determine the fraction of resources devoted to productive endeavors and the efficiency with which the economy uses those resources. The data show that various measures of financial development predict how fast economies will grow in the future. Thus, policies that bolster financial development will accelerate economic development.

The second part of the chapter evaluated whether openness to foreign banks promotes financial development. Foreign banks may promote financial development directly by providing high-quality financial services to the domestic market and by exerting downward pressure on the prices of financial services. Foreign banks also enhance financial development by spurring domestic banks to improve

the quality of their services and cut costs. Further, they encourage the upgrading of ancillary institutions such as accounting, auditing, and rating firms, thereby improving the quality and flow of information about firms and banks. And foreign banks will facilitate domestic financial development by intensifying pressures for governments to improve the legal, regulatory, and supervisory systems.

In comparison with these benefits, the potential negative effects of foreign banks on financial development seem remote. Foreign banks play at most a peripheral role in capital flight. In most countries, foreign banks are minor participants, so that some easing of entry restrictions should not create fears of foreign domination of the domestic financial system.

While foreign banks initially try to exploit market niches where they have exhibited competitive success in other countries, this natural business tactic will improve financial services in the domestic market. Eventually, foreign banks may attempt to compete more broadly as they gain experience about the domestic market. Thus, the belief that foreign banks will initially service some segments of the market should not deter countries from liberalizing entry restrictions. Although opening to foreign banks may place greater burdens on the supervisory system, financial liberalization efforts in general should be coordinated with improved supervisory capacity.

In sum, the benefits to be gained from easing foreign bank entry restrictions in developing countries where foreign banks currently play a very small role in the domestic financial system seem much greater than the costs and risks involved.

Appendix 6–A: McFadden's Study of Foreign Banks in Australia

Australia liberalized foreign bank entry in 1984. Prior to 1984, foreign banks had operated in Australia through finance companies and merchant banks and held 17 percent of financial assets. They had been restricted from foreign exchange transactions, deposit taking, and direct access to the payment system. The financial system was concentrated. The four largest trading banks (Westpac, National Australian Bank, ANZ, and the Commonwealth Bank of Australia) held 60 percent of financial assets and 80 percent of deposits, and had 5,500 branches nationwide.

Foreign banks had to be locally incorporated subsidiaries and were subject to the same legislative, prudential, and tax regulation as domestic trading banks. Reciprocity was required. Banks had to be at least 50 percent domestically owned to provide a broad range of banking services, although exceptions were routinely granted. Eight of the

original 16 banking licenses went to wholly foreign-owned banks, including Citibank, Barclays, NatWest, Bankers Trust, and Deutsche Bank.

Citibank. Extending its global strategy and building on its preexisting finance company, Citibank pursued investment and commercial banking, foreign exchange and risk management services, and retail banking, especially for high-income individuals. Citibank targeted the 200 largest firms in Australia in attempting to expand its corporate and investment banking business. Citibank offered full electronic trade finance to corporations that greatly lowered various transaction costs. In retail banking, Citibank developed its money market, ATM credit card, mortgage instruments, and home financing products. In terms of risk management, Citibank offered full swap warehouses and other sophisticated risk-trading facilities. So far, Citibank has been generally successful, even in retail banking and home financing.

Chase Manhattan. In a joint venture with Australia Mutual Provident Society, Chase-AMP Bank is attempting to combine banking with the customer base, agents, and offices of the huge AMP insurance company to provide a wide array of services. They have taken off slowly, as Chase did not have earlier experience in Australia, and the insurance-banking mix has not yet had positive synergies.

Bank of Tokyo. Building on its existing merchant bank, Bank of Tokyo has succeeded in expanding services to primarily large Japanese corporations. This strategy has also helped Mitsubishi to expand its operations in Australia successfully.

Bankers Trust and Barclays. They have used their new banking licenses to expand operations in Australia. They are expanding their client base, providing foreign exchange and money market services, and doing more syndicated funding.

General Conclusions. Domestic banks improved their operations, invested in new technologies, cut costs, and competed intensively with foreign banks, so that foreign banks were less profitable initially than many analysts had expected. Foreign bank entry has coincided with lower interest rate margins, lower spreads over the Treasury Bill rate for corporations, and better service for individuals than were available before Australia liberalized foreign bank entry.

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