

Financial FDI and Host Countries: New and Old Lessons

Linda Goldberg¹
Federal Reserve Bank of New York

March 6, 2003 Preliminary

In the 1990s, foreign direct investment became the largest single source of external finance for many developing countries. For the most part, research into the causes and effects of FDI has mainly focussed on manufacturing and real production activity. This research, interestingly, has been conducted orthogonally to the recent spate of research efforts and methods used for addressing financial FDI. Cross-citation of these literatures is seldom observed. This orthogonality is surprising: financial FDI shares many of the features of more general FDI in productive services.

Conceptually, in each case a foreign producer of goods or services makes a two-fold decision. First, he decides whether to service a particular market; second, he determines whether this market be served through exports or through setting up local production. While manufacturers use the language of exports or production by multinationals, there is a direct financial services (and in particular banking) analogue to this two-step decision: first, whether to provide lending, deposit-taking and other services to a market; and if so, second, whether to use cross-border activities (arms-length transactions) or foreign direct investment in the form of setting up branches or subsidiaries followed by local lending (for example).

In this paper, I argue that some of the established lessons from general FDI research directly pertain to financial FDI. However, financial FDI also raises a distinct set of concerns. My review of some of the main findings and policy themes of the general FDI research developed in the context of “manufacturing” focuses mainly on the host country implications of FDI, especially in the context of emerging market economies. It covers technology transfers, productivity spillovers, wage effects, macroeconomic growth, and fiscal and tax concerns. I also discuss which host country implications of general FDI are likely to extend to financial services. The final sections address the other issues that arise specifically in the context of financial sector FDI.

The extensive knowledge base already developed for FDI more generally contains many useful insights for financial FDI more specifically. Further research on financial FDI could integrate those insights with findings stemming from the dimensions along which FDI in banking and finance raises distinct concerns and benefits for the host country. Evidence on the latter themes will provide a better base for debate and perhaps policy attention. In particular, such evidence informs the question of whether emerging market governments should provide incentives for financial FDI inflows.

¹ The views expressed in this paper are those of the individual author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System. Address correspondences to Linda S. Goldberg, Federal Reserve Bank of NY, Research Department, 33 Liberty St, New York, N.Y. 10045. Tel: 212-720-2836; fax: 212-720-6831; email: Linda.Goldberg@ny.frb.org.

Executive Summary of the effects of FDI on host countries.

A well-established literature explores the causes and consequences of FDI in productive services, generally interpreted as manufacturing, but sometimes extending to mining and natural resource extractive services. This research has often been conducted using data from individual countries or industries, as opposed to taking the form of sweeping multi-country studies. Consequently, the stylized facts arising from this literature are based on a combination of theoretical arguments supplement by selective case studies. The case studies employ distinct “definitions” of FDI – sometimes using a flow definition (for example, the foreign investment that took place within a particular period of time) or a stock definition, which is meant to represent the total cumulative value of all foreign investment up until some point in time. Distinctions are seldom made between FDI in the form of mergers and acquisitions, versus those done as greenfield (de novo) investments.

FDI is an activity that occurs as part of a multinational’s broader strategic plan and responds to fluctuations in exchange rates and market conditions. The sometimes lumpy reallocation of capital across borders may occur when governments reduce their protection of inefficient or corrupt local industries.² These features are common to manufacturing industries, resource extractive industries, and financial services.

In brief, multinationals and FDI into emerging markets generally have a number of important effects on emerging market host countries, some of which are specific to FDI in financial services. These effects include:

- Improved allocative efficiency. This can occur when foreign investors enter into industries with high entry barriers and then reduce local monopolistic distortions. The presence of foreign producers may also induce higher technical efficiency: the increased competitive pressure or some demonstration effect may spur local firms to more efficient use of existing resources.
- Higher rates of technology transfer and diffusion. While there is evidence of technological improvements from FDI, and a presumption that FDI will consequently stimulate economic growth, the strength of these effects is disputed.
- Higher wages are induced by FDI into host countries, although sometimes these wage effects are limited to the foreign-owned production facilities and do not spillover more broadly.
- FDI in financial services leads to improved regulation and supervision. Sometimes these improvements occur with a lag, as supervisors in host countries may be initially unprepared for evaluating the new products and processes introduced by foreign entrants.

² Dixit and Kyle (1985) provide an elegant conceptual exposition.

- Foreign banks are procyclical lenders in emerging markets. Domestic privately-owned banks also are procyclical lenders, so the presence of foreign banks does not aggravate the boom-bust cycle in lending and international capital flows. Foreign entrants may introduce a more diversified supply of funds, in principle leading loan supply to be less procyclical but also more sensitive to foreign fluctuations.
- Foreign bank entry into emerging markets reduces the incidence of crises, but enhances the potential for greater contagion through common lender effects. The contagion issue is reduced when foreign banks have a stronger subsidiary presence, as opposed to supporting local markets through cross-border flows.
- In the literature on FDI (real side) there is some skepticism about whether the real benefits from FDI to the host country justify the sometimes large incentives offered to attract foreign investors. The special features of financial FDI add another dimension to this debate, and warrant further discussion.

I. Does FDI lead to technology transfer and productivity spillovers?

Development economists argue that multinationals, through FDI, help to fill an “idea gap” between developed and developing countries and provide enhanced opportunities for developing country growth (Romer 1993). According to this view, foreign direct investors in a country presumably have access to productive knowledge that is not readily available to producers in the host country. However potent, such productive knowledge may be intangible, taking the form of technological know-how, marketing and managing skills, export contacts, coordinated relationships with suppliers and customers, and reputation.

The concept of technology transfer between countries has a long and rich research history.³ Nonetheless, formal evidence is mixed on the extent of technology transfers and productivity spillovers. Some studies conclude that domestic firms in sectors with more foreign ownership are more productive (see, for example, Blomstrom 1989 on Mexico) than firms in sectors with less foreign participation. Other studies dispute the spillover benefits of FDI into local markets (see Germidis 1977 for a discussion of spillovers in the OECD). One reason for the disagreement between researchers stems from the extent to which the researchers properly controlled for the conditions in a country or sector prior to the advent of FDI. Foreign investment may enter sectors where firms are ex ante more productive, so that foreign entry per se does not have much of an effect on local productivity.

Other researchers conclude that productivity and technology spillovers exist, but could depend on the structure of host country production activity. Small plants may have the largest productivity gains from foreign entry. Some local plants may lose workers and experience productivity declines. In some cases the gains from foreign investment

³ See Horstmann and Markusen 1989 for an early discussion.

appeared to be entirely captured by the joint ventures. (Aitken and Harrison 1993, 1999 provide evidence for Venezuela and preliminary results for Indonesia).

Overall, while the theoretical point of technology transfer from FDI is compelling, empirically the strength of technology transfer and aggregate productivity effects remains debated in the context of “manufacturing” FDI.

These technology transfer and productivity themes have direct counterparts in the financial FDI literature. Instead of using the language of productivity, recent research in this area asks whether foreign bank entry alters the efficiency of foreign-owned and domestically-owned banks. Foreign banks operating in developing countries appear to be more efficient than their domestic counterparts, whether privately owned or government owned. Domestic banks are forced to become more efficient after foreign entry, especially in the business lines in which foreign banks choose to compete.

The studies that reach these conclusions take cross-country and case study approaches. Using data from a sample of 80 countries, Claessens, Demirguc-Kunt and Huizinga (2000) show that foreign entry reduces the profitability of domestic banks and enhances their efficiency. Country studies mainly using bank balance sheet data reach similar types of conclusions for the Philippines (Unite and Sullivan 2001), Colombia (Barajas, Steiner and Salazar 2000), and Argentina (Clarke, Cull, D’Amato and Molinari 2000).

This financial FDI research, to my knowledge, does not directly distinguish between productivity enhancements due to changes in the market structure of the industries versus those due to technology transfers between foreign banks and domestic banks. Most of the discussion draws on arguments relating to industry competitive structure: foreign entry reduces the monopolistic excesses of domestic banks. The past decade has been characterized by a significant amount of bank consolidation, with foreign entrants into emerging markets a component of (and partial trigger for) this process. Interestingly, Gelos and Roldos (2002) show convincingly that this consolidation has been associated with efficiency improvements but not reduced competition in local financial markets.

II. Do FDI inflows change host country wages?

The productivity and technology transfer arguments lead directly to the question of whether local workers benefit (in terms of wages) from foreign entry. As posed in the context of the manufacturing FDI literature, when the foreign firm possesses some intangible productive knowledge there should be human capital accumulation by local workers. With the technology transfer, the host-country employees of the foreign firm should develop greater human capital. This accumulation of human capital should manifest itself in greater productivity and be rewarded by higher wages.

Empirical studies have tied higher levels of foreign investment to higher wages. In Mexico and Venezuela, this wage growth was experienced only for the workers in foreign-owned firms without broader spillovers through the host country labor markets.

In the United States, there have been smaller wage effects from foreign investment, but these wage gains have spilled over more into local labor markets (Aitken, Harrison and Lipsey 1996). In Indonesian industries, wages paid in domestically-owned manufacturing plants taken over by foreign firms increased sharply relative to wages paid in those plants that remained in domestic hands. These results persisted even after controls were introduced to account for the initial characteristics of the plants that were taken over by foreign investors (Lipsey and Sjöholm 2002).

The same types of theoretical arguments concerning the wage effects of FDI should apply to workers in emerging market financial services industries. However, while there is some suggestive evidence supporting this -- bank balance sheet data have shown that foreign bank costs (overall) are lower and domestic bank costs are pushed down by foreign entry -- there have not to my knowledge been systematic analyses of the wage implications of financial FDI in emerging markets.

A related theme is the employment effects of FDI. The overall employment implications for the host economy, in which the jobs of the entrant and surrounding economy are taken together, most likely depend on whether the FDI takes the form of greenfield investment (referred to as *de novo* in the financial services industry) or occurs via mergers and acquisitions of pre-existing plants (or banking networks). Greenfield investments, like the construction of a new production plant, are expected to generate more employment on net. This job growth might strongest if the new plant does not directly compete with other local production facilities, especially in serving thin host country markets. The net employment effects also could be strong if there are agglomeration externalities, so that the infrastructural improvements have spillovers on other firms locally and all local producers could potentially gain.⁴ These points are relevant for studies of general FDI, which do not typically distinguish between types of FDI, and would be expected to also be quite relevant for financial FDI.

The net employment effects of merger and acquisition FDI are less transparent. If the M&A implies that consolidation occurs over an inherited bloated infrastructure, there may be job loss. There may be fewer individuals employed at higher wages in a plant or banking system that ultimately is operating more efficiently.

III. Do FDI inflows accelerate macroeconomic growth?

Other studies concentrate on the aggregate implications of FDI, sometimes using data from larger groups of countries and taking the form of growth regressions. Part of the motivation is drawn from question of whether an idea gap had held back EME growth,

⁴ Job creation by a single plant is not always an appropriate welfare metric. While the foreign plant employs workers and pays higher wages, some of these workers are redistributed from other local plants. But, in a situation where the foreign investor takes over a local plant, restructuring could lead to some job loss, with only the remaining employees getting higher wages – with the producer potentially generating larger income and tax revenues for local governments.

and the potential effect of FDI as inducing a catch-up process (Romer 1993). The cross-country evidence is debated.

More robust evidence on FDI and aggregate growth is found in a number of developing country studies (see Lipsey 2000 for an overview). Research suggests that inward investments in Greece, Taiwan, Indonesia, and Mexico have contributed significantly to their growth. However, research that contains detailed industry-level data concludes that growth spillovers across industries may be driven by the industries into which FDI is targeted. Spillovers are not expected to occur across all industries – the spillovers and growth ramifications are expected to be strongest when foreign affiliates and local firms are in more direct competition with each other, as may be the case in previously protected industries.

There are two strands of research that specifically tie into the question of whether financial FDI stimulates emerging market growth. One strand of research looks broader than financial FDI per se, and considers the growth implications of financial liberalization. The issue of financial FDI, as opposed to portfolio investments or other forms of capital inflows, is not explicitly addressed. In this literature, financial liberalization events are usually defined in terms of regulatory changes such as the relaxation of capital controls or lifting of interest rate ceilings. Despite considerable research output, the extent of long term growth benefits of capital account liberalizations is hotly debated and a consensus view has not developed. Sharply contrasting results have been generated by researchers due to differences in country coverage, sample periods, inclusion of crisis controls, and indicators of financial liberalization used in research.⁵

Even without evidence that financial liberalization conclusively leads to higher sustained economic growth, financial liberalization is nonetheless expected to lead to more efficient allocation of investment activity within and across countries. Financial liberalization tends to relax financing constraints on producers in developing countries, and make them less adversely influenced by financial crises. (Galindo and Schiantarelli 2002).

The second strand of research explicitly focuses on the effects of foreign bank entry on aggregate growth rates, but less work has been done in this area. Foreign banks sometimes enter as a component of a larger scale financial liberalization and banking privatization effort, and sometimes enter as local governments seek to recapitalize their financial systems in the wake of crises. Outside of crisis periods, foreign banks might be expected to contribute to growth by providing capital to worthy but previously credit constrained borrowers, and by not crowding out credit provision to worthy borrowers who are outside the scope of their business model.

U.S. bank credit provision to Latin American countries grew faster and was less sensitive to local cycles than credit provision by domestically-owned banks (Dages, Crystal and Goldberg 2002, and Dages, Goldberg, and Kinney 2000). The composition of credit provision also is important, and some research asks whether small businesses that might

⁵ For recent examples and surveys, see Edison, Klein, Ricci, and Slok 2002; Eichengreen and Leblang 2002.

rely on bank credit have constrained access with foreign bank entry. As previously noted, foreign banks operating in Latin America have been providing credit to local constituents in similar patterns as healthy domestically-owned banks. Clarke, Cull, and Martinez Peria (2002) provide detailed evidence for Latin American countries, and conclude that – other than biases in borrower orientation often linked to bank size (large banks lend relatively less to SMEs) – there is not a systematic bias in orientation specifically associated with foreignness. Bonin and Abel (2000) also argue in the context of Hungary that, on aggregate, foreign entry could be associated with expanded SME credits if the domestic banks have to more aggressively search for a broader clientele for lending.

IV. Are there significant fiscal and tax questions raised by FDI?

Another area of research on FDI (in manufacturing) addresses the implications of public finance decisions concerning multinationals⁶ and the host country governments. One pertinent issue is that of incentives offered to foreign investors in order to attract them to a country (or locality within a country). Efforts to attract multinationals and foreign investment capital have been extensive. UNCTAD (2001:6-7) reports that nearly 95 percent of the almost 1200 changes in national FDI legislation during 1991 through 2000 were favorable to foreign investors --- sometimes taking the form of special incentives to foreign enterprises, including lower income taxes, income tax holidays, import duty exemptions, and subsidies for infrastructure.

Researchers and policymakers, in thinking about the benefits of FDI, are asking whether (quantitatively) there is reason to believe that these benefits justify the costs. Oman (2000), for example, argues that when governments compete actively against each other for FDI, ultimately profits from the investments are shifted from the host country to multinational enterprises. Blomstrom and Kokko (2003) argue that the types of long-term benefits that are generated by FDI may not justify the short-term costs. Governments may make excessive long term financial commitments, because FDI may generate employment and political gains in the short term.

“strong promotion efforts show that the government is actively doing something to strengthen employment, productivity, growth, or some other policy objective ... Another reason is that some of the perceived benefits (in particular, the jobs created by FDI) are easily observable while some of the costs (particularly related to tax breaks and fiscal incentives) are distributed over long periods of time and hard to measure.”

Blomstrom and Kokko 2003.

⁶ See *The Effects of Taxation on Multinational Corporations*, edited by Martin Feldstein, James Hines, Jr. and R. Glenn Hubbard (NBER and U. Chicago Press, 1995).

It is natural to ask whether these arguments also pertain to financial FDI. As discussed further below, there are a number of important dimensions along which financial FDI is expected to have distinct implications than more general forms of FDI. The calculus of costs and benefits of actively promoting and subsidizing such foreign entry is a topic worthy of more discussion. Likewise, it is worth discussing alternative approaches to achieving and maximizing the desired benefits from FDI.

V. How is Financial FDI different?

Because of the role of the financial sector in credit intermediation, local economic activity, and crises, FDI in financial services raises a number of distinct issues for the host country. In this section I briefly discuss the importance for institutional development and governance (especially related to the banking sector), the multiplier on foreign and domestically generated business cycles, crisis contagion, and macroeconomic growth and stability more generally. I do not delve substantively into the other important range of issues surrounding the alternative modes of entry into a country (de novo versus merger and/or acquisitions with local banks) or the alternative organizational forms for bank entrants (branch, subsidiary, or as a representative agent of the parent bank).

Financial FDI may lead to improved bank supervision, with regulatory spillovers

The entry into emerging markets of foreign banks that are healthier than domestic banks implicitly allows a country to import stronger prudential regulation and increase the soundness of the local banking sector. In the cases of Argentina, Chile, and Colombia, for example, foreign banks have contributed to enhanced domestic financial stability by engaging in more aggressive risk management techniques (Crystal, Dages and Goldberg 2002). Calomiris and Powell (2001) argued that Argentina's bank regulatory system in the late 1990s was one of the most successful among emerging market economies. Reliance on market discipline was viewed as playing an important role in prudential regulation by strengthening risk management among banks.

But the effects of foreign banks and the challenges they pose to local regulators, depend in part on their mode of entry. New foreign entrants can pose particular changes to local supervisors. Major international banks try to build market share by offering a variety of new financial products, including OTC derivatives, structured notes, and equity swaps. These new derivative products can provide improved opportunities for hedging a variety of risks. However, some new products can also be used to evade prudential regulations and take on excess risks, especially in countries with weak financial systems with under-prepared supervisors (Garber 2000). One clear implication is that local supervisors in emerging markets may need to make early investments in upgrading their skills in order to better evaluate the use and effects of new products. Other challenges for supervisors

arise in the context of relationships with parent banks, and may depend on when the foreign entry is accomplished through branches or subsidiaries.⁷

Foreign bank entry also raises issues of competition policy within host country banking systems. While the actual experiences of host countries have been extensively elaborated elsewhere (see the collection of articles in BIS 2001, and its overview by Hawkins and Mihaljek), on average consolidation has occurred without deterioration of the competitiveness of the financial services industry within a country (Gelos and Roldos 2002).

The enhanced competitiveness in financial systems can have mixed near-term effects on the overall soundness of banks. In Colombia's financial sector, despite efficiency improvements, foreign bank entry was associated with worse loan quality in domestic bank portfolios (Barajas, Steiner and Salazar 2002). One challenge to regulators is in formulating and implementing appropriate approaches to those banks that will not survive in the more competitive environment.

Another challenge arises in the case where the financial services industry does become highly concentrated with monopolistic pricing tendencies exerted by banks (for example). If foreign banks are among the few surviving banks, local regulators may be tempted to conclude that foreign banks bear specific responsibility for adverse outcomes. Yet in many cases, foreign bank entry occurs as part of a process of larger scale restructuring and recapitalization of the EME financial system. More concentrated market power may have occurred regardless of whether owners were foreign or domestic. Even with monopolistic pricing, there may be other benefits through scale economies and improved services that are the by-products of consolidation. These issues challenge regulators to engage in careful cost-benefit analyses and policy reactions.

Foreign banks do not appear to magnify local business cycles.

In principle, bank lending activity can either be procyclical or countercyclical with respect to local business cycles and other shocks. On the loan supply side, the availability of loanable funds via the deposit base contributes to procyclicality. To the extent that foreign bank entrants are less reliant on host country funding sources, and more reliant on foreign sources of funds, the procyclicality of their supply of loanable funds may be reduced. Loan demand can either be procyclical or countercyclical. Procyclicality can arise as individuals or businesses borrow more to expand their holdings in good times, or countercyclical as individuals try to intertemporally smooth consumption.

⁷ One recent study considers the stability of cross border versus FDI flows in banking for Central and Eastern European countries (Buch, Kleinert, and Zajc 2003). In preliminary work, the authors argue that FDI should have an additional stabilizing feature since it should allow banks in CEECs to draw on the liquidity buffer of their headquarters abroad. Branches and subsidiaries are not distinguished in the conceptual presentation.

Other arguments for procyclicality rely on information asymmetries between borrowers and lenders, as argued within a financial accelerator view of credit cycles.⁸ Or, as Borio, Furfine, and Lowe (2001) contend, procyclicality may be the result of inappropriate responses by financial market participants to changes in risk over time. These inappropriate responses can be caused by under-estimating risk in good times and over-estimating risk in bad times. Inappropriate credit cycles can also derive from market participants having incentives to react to risk, even if correctly measured, in ways that are socially suboptimal. Related arguments for procyclicality stem from bank provisioning practices and their links to rules on regulatory capital (Cavallo and Majnoni 2001).

These cyclical lending responses could potentially differ between foreign-owned and domestically owned banks. Goldberg, Dages, and Crystal (2002) find that while foreign banks are procyclical lenders, they do not appear to magnify the boom-bust cycles in emerging markets. Analysis of individual bank data from Chile, Colombia, and Argentina supports broad similarities between the lending patterns of private domestically-owned domestic banks and longer-established foreign banks. The similarities with newer established foreign banks are less systematic. While foreign banks had higher average loan growth, foreign banks did not add significant volatility to local financial systems or act as relatively destabilizing lenders.⁹

In fact, foreign banks can reduce the magnitude of host country cycles if they reduce the incidence of crises.

The boom/ bust cycles in international capital flows are often derided as wreaking havoc on economies, with lending booms contributing to financial crises. Financial liberalization, by giving banks and other intermediaries more freedom of action and allowing them to take greater risks, is sometimes argued to increase the financial fragility in an emerging market. Studies by Demirguc-Kunt and Detragiache (1998, 2001), as well as work by Rojas-Suarez (2001), find that financial liberalization (defined as interest rate liberalization) has costs in terms of increased financial fragility, especially in developing countries where the institutions needed to support a well-functioning financial system are generally not well-established.

While such works introduce an important dimension in the discussion of the costs and benefits of financial liberalization, they do not, however consider the contributions of banks sorted by ownership structure, nor break out the types of flows that contribute to crises. As Crystal, Dages, and Goldberg (2002) show, foreign owned banks may contribute to the overall soundness of local banking systems via more aggressive screening and treatment of problem loans. If foreign entry spurs additional regulatory improvements, financial crisis risk declines. Demirguc-Kunt, Levine, and Min (1998)

⁸ The “financial accelerator” argument maintains that information asymmetries between lenders and borrowers contribute to the procyclicality of lending. When economic conditions are subject to an adverse shock, and collateral values decline, even those borrowers with profitable projects have difficulty obtaining funding.

⁹ See also Goldberg (2002), Dages, Kinney and Goldberg (2000), and Horvath (2002).

relate foreign bank entry per se to the probability that a banking crisis will occur. The foreign bank presence was found to have a negative and statistically significant coefficient, leading the authors to conclude that (controlling for other factors likely to produce banking crises) greater foreign bank participation had a stabilizing effect.

The transmission of shocks across borders is another issue that bears on financial crises. Foreign banks may contribute to contagion through common lender effects, as documented in Van Rijckeghem and Weder (2000). Foreign banks could also be subject to foreign cyclical flows. However, any private bank with access to foreign loanable funds can be similarly effected: foreign cycles have been shown to effect the lending and deposit bases of both domestically and foreign owned private banks in emerging markets (Crystal, Dages, and Goldberg 2002). More evidence is needed on the question of whether foreign banks have access to – and receive – additional capital from their head offices in times of stress. Anecdotal evidence suggests that there is not a systematic relationship, but this warrants more rigorous study.

Finally, it is worth noting that foreign banks may contribute to domestic financial stability by being within a country's borders, rather than abroad. If flight to quality occurs under stress periods, it may be better to have domestic depositors keep their money within the domestic financial system (to be reintermediated locally) rather than leave the country through capital flight. Martinez-Peria and Schmukler (1999) document that depositors recognize difference in health and efficiency of banks, moving their assets to better functioning banks or demanding higher deposit rates. Locally generated claims from foreign-owned banks substitute, in part, for cross border flows, with the latter sometimes more volatile.¹⁰

Foreign banks may encourage more efficient capital allocation.

Researchers have broadly concluded that FDI flows (in manufacturing) are associated with more efficient allocation of capital in emerging market economies. These capital allocation arguments may be especially pertinent in the case of financial FDI. Prior to financial sector liberalization and reform, some governments use the local banking system as a tool for providing directed credit to politically favored constituents or favored but loss-making sectors of the economy. The banks implicitly play a role in patronage, “development finance”, and subsidize levels of activities that might not be viable on market terms.

¹⁰ More evidence is needed on the extent to which there is substitutability between cross border flows and locally-generated claims by foreign branches and subsidiaries. There are direct parallels between these types of questions in financial FDI and questions long raised in the area of real-side FDI. In manufacturing industries, there is no clear pattern of substitutability versus complementarity in bilateral flows between Latin American countries and the United States. But, manufacturers in different countries may engage in distinct FDI strategies. Research has shown that for Southeast Asian countries, FDI from Japan enhanced Japanese exports to those countries (consistent with intermediate input trade) while FDI from the United States substituted for exports from the United States to Southeast Asia. FDI from these two sources did not systematically influence exports from the U.S. or Japan to Latin American countries. (Goldberg and Klein 1998, 2001).

Some suggestive evidence of the costliness of such strategies is found in work by LaPorta, Lopez-de-Silanes, Shleifer (2002). Using data from around the world, they argue that higher levels of government ownership of banks is associated with lower growth of per capita income and productivity. Sapienza (2002), in a fascinating study of state-owned banks in Italy, shows that public bank lending has a pattern of rewarding political supporters.

While serving as a means of fiscal stimulus, this type of directed lending crowds out intermediation to worthy private borrowers. If banks are better regulated and subject to parent bank oversight, foreign banks operating in EMEs may be better able to resist local suasion. As such, they may better discipline host country fiscal or monetary “irresponsibility” and be less amenable to forced purchases of government bonds or forced lending to favored political constituents.

Are there FDI-related principles that should be espoused?

In the literature on FDI (real side) there is some skepticism about whether the real benefits from FDI to the host country justify the sometimes large incentives offered to attract foreign investors. These investment incentives may be off-budget items in developing countries – for example as tax holidays that do not require payment of scarce public funds. As Blomstrom and Kokko (2003) exposit, the employment gains, efficiency improvements, and knowledge spillovers that some governments expect *may* be significant. However, they may not be large enough to justify the large cumulative costs of investment incentives. Moreover, if foreign and domestic investors are quite similar in their effects, investment incentives to foreigners may have negative distortionary effects on competition. There also is the *possibility* of negative spillovers to industries outside of those targeted for foreign investment. The calculus of these effects may be case specific and do not unambiguously support active support of foreign investment.

The special features of financial FDI add another dimension to this debate, and warrant further discussion. There are some broad similarities, but also some differences, between the effects of manufacturing FDI and financial FDI. Financial FDI can support institutional development and governance, improve the mix of financial services and risk management tools of a host country, and potentially reduce the sharp crises associated with financial underdevelopment in emerging markets. Financial FDI can initially pose strong regulatory challenges to local supervisors, who need to develop expertise in the practices and products introduced into their local economies. (The international policy community can potentially facilitate this through training efforts). The employment effects of financial FDI are more subtle, depending in part on whether the investment is greenfield or merger and acquisition. In the latter case, the effects also depend on whether the acquired institution was financially sound or needing restructuring, regardless of the nationality of the new owners.

One key policy question is whether developing countries, going beyond the decision point of whether or not to open to financial foreign investment, should actually actively encourage such financial FDI through incentive programs. On net, governments may not expect financial FDI (for example in banking) to stimulate banking employment. But, more potentially more pressing may be the expectation that an investment is being made in local financial system strength and stability. To date, the evidence is broadly consistent with these expectations.¹¹ However, careful discussion and further rigorous analyses will continue to inform this important question and reach policy prescriptions.

References:

Aitken, Brian and Ann Harrison. 1999. "Do Domestic Firms Benefit from Direct Foreign Investment? Evidence from Venezuela" *American Economic Review* vol.89 no.3 June pp.606-618.

Aitken, Brian, Ann Harrison, and Robert E. Lipsey . "Wages and Foreign Ownership: A Comparative Study of Mexico, Venezuela, and the United States", *Journal of International Economics*, Vol. 40, No. 3/4, May 1996, pp. 345-371.

Bank for International Settlements, 2001. *The banking industry in the emerging market economies: competition, consolidation, and systemic stability*. BIS papers no. 4 Monetary and Economics Department (August).

Barajas, Adolfo, Roberto Steiner, and Natalia Salazar. 2000. "The Impact of Liberalization and Foreign Investment in Colombia's Financial Sector." *Journal of Development Economics* 63(1): 157-96.

Barth, James, Gerard Caprio, and Ross Levine. 2001. "Banking Systems Around the Globe: Do Regulation and Ownership Affect Performance and Stability?" in Frederic Mishkin, ed., *Prudential Regulation and Supervision: What Works and What Doesn't*. Boston Ma: National Bureau of Economic Research.

Blomstrom, Magnus. 1989. *Foreign Investment and Spillovers*. London: Routledge.

Blomstrom, Magnus, and Ari Kokko. 2003. "The Economics of Foreign Direct Investment Incentives" NBER 9489. <http://papers.nber.org/papers/W9489>

Bonin, John and I. Abel. 2000. "Retail Banking in Hungary: A Foreign Affair?" William Davidson Institute working paper no. 356.

Borio, C., C. Furfine, and P. Lowe. 2001. *Procyclicality of the financial system and financial stability: Issues and Policy options*. BIS working paper.

¹¹ If manufacturing FDI evidence is a guide to where spillovers are likely, Kokko (1994) shows that the incidence of spillovers is related to a host country's ability to absorb them.

Buch, Claudia, Jorn Kleinert, and Peter Zajc. January 2003. "Financial Integration and Stability in Transition Economies: Does the Mode of Entry Matter?" manuscript, Kiel Institute for World Economics.

Burdisso, Tamaro, Laura D'Amato, and Andrea Molinari. 1998. "The Bank Privatization Process in Argentina: Toward a More Efficient Banking System?" Unpublished paper, Banco Central de la República Argentina, October.

Calomiris, Charles and Andrew Powell. 2001. "Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992-1999." In *Prudential Supervision: What Works and What Doesn't*, edited by Frederic Mishkin (NBER and University of Chicago Press).

Cavallo, Michele and Giovanni Majnoni. 2001. "Do Banks Provision for Bad Loans in Good Times?" World Bank Policy Research working paper no. 2619.

Claessens, Stijn, Asli Demirguc-Kunt, and Harry Huizinga. 2000. "The Role of Foreign Banks in Domestic Banking Systems." In Stijn Claessens and Marion Jansen, eds. *The Internationalization of Financial Services: Issues and Lessons for Developing Countries*. Boston MA: Kluwer Academic Press.

Claessens, Stijn, Asli Demirguc-Kunt, and Harry Huizinga. 2001. "How does foreign entry affect domestic banking markets?" *Journal of Banking and Finance*, 25, pp.891-911.

Clarke, George, Robert Cull, Laura D'Amato, and Andrea Molinari. 1999. "The Effect of Foreign Entry on Argentina's Banking System." In *The Internationalization of Financial Services: Issues and Lessons for Developing Countries*, edited by Stijn Claessens and Marion Jansen. Dordrecht, The Netherlands: Kluwer Academic.

Clarke, George, Robert Cull and Maria Soledad Martinez Peria. 2002. Does Foreign Bank Penetration Reduce Access to Credit in Developing Countries? Evidence from Asking Borrowers. Manuscript.

Clarke, George, Robert Cull and Maria Soledad Martinez Peria. 2002. "Foreign Bank Entry: Experience, Implications for Developing Countries, and Agenda for Further Research". Manuscript June 2002.

Crystal, Jennifer, B. Gerard Dages, and Linda Goldberg. 2001. "Does Foreign Ownership Contribute to Sounder Banks? The Latin American Experience. In *Open Doors: Foreign Participation in Financial Systems in Developing Countries*, edited by Robert Litan, Paul Masson, and Michael Pomerleano (Washington DC: Brookings Institution and the World Bank): 217-266.

Dages, B. Gerard, Daniel Kinney, and Linda Goldberg. 2000. "Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina" in Federal Reserve Bank of New York, *Economic Policy Review* 6(3): 17-36.

Demirguc-Kunt, Asli and Enrica Detragiache. 1998. "The Determinants of Banking Crises: Evidence from Industrial and Developing Countries." *IMF Staff Papers* 45(1): 81-109.

Demirguc-Kunt, Asli and Enrica Detragiache. 2001. "Financial Liberalization and Financial Fragility" in *Financial Liberalization: How Far, How Fast?* Edited by Gerard Caprio, Patrick Honohan, and Joseph Stiglitz (New York: Cambridge University Press).

Demirguc-Kunt, Asli, Ross Levine, and Hong-Ghi Min. 1998. "Opening to Foreign Banks: Issues of Stability, Efficiency, and Growth." In Seongtae Lee, ed., *The Implications of Globalization of World Financial Markets*. Seoul: Bank of Korea.

Detragiache, Enrica and Poonam Gupta. 2002. "Foreign Bank in Emerging Market Crises: Malaysia, 1996-98" International Monetary Fund, Washington DC.

Dixit, Avinash and A.S. Kyle. 1985. "The Use of Protection and Subsidies for Entry Promotion and Deterrence." *American Economic Review* 75: 139-152.

Edison, Hali, Michael Klein, Luca Ricci, and Torsten Slok. 2002. Capital Account Liberalization and Economic Performance: Survey and Synthesis. IMF working paper (May).

Eichengreen, Barry and David Leblang. 2002. Capital Account Liberalization and Growth: Was Mr. Mahathir Right? NBER working paper no. 9427 (December).

Focarelli, Daio and Alberto Franco Pozzolo. "Where do Banks Expand Abroad? An Empirical Analysis." Manuscript.

Galindo, Arturo, Alejandro Micco, and Serra, "Better the Devil that You Know: Evidence on Entry Costs Faced by Foreign Banks" IADB September 2002.

Galindo, Arturo, and Fabio Schiantarelli, "Credit Constraints on Firms in Latin America: An Overview of the Micro Evidence" IADB 2002.

Garber, Peter. 2000. "What you see vs. what you get: Derivatives in International Capital Flows" in *Managing Financial and Corporate Distress: Lessons from Asia*, edited by Charles Adams, Robert E. Litan, Michael Pomerleano (Brookings).

<http://brookings.nap.edu/books/0815701039/html/362.html#pagetop>

Gelos, Gaston and Jorge Roldos. 2002. Consolidation and Market Structure in Emerging Market Banking Systems. Manuscript.

Germidis, Dimitri. Transfers of technology by multinational corporations. Paris. OECD 1977.

Goldberg, Linda. 2002. "When Is Foreign Bank Lending to Emerging Markets Volatile?" in *Preventing Currency Crises in Emerging Markets*, edited by Sebastian Edwards and Jeffrey Frankel (NBER and University of Chicago Press).

Goldberg, Linda, B. Gerard Dages, and Jennifer Crystal. 2002. "The Lending Cycles of Banks in Emerging Markets: Foreign and Domestic Owners Compared". Manuscript, Federal Reserve Bank of New York.

Goldberg, Linda and Michael Klein. 1998. "Foreign Direct Investment, Trade and Real Exchange Rate Linkages in Developing Countries", 1998, in *Managing Capital Flows and Exchange Rates: Perspectives from the Pacific Basin*, edited by Reuven Glick. (Cambridge University Press).

Goldberg, Linda and Michael Klein. 2001. "International Trade and Factor Mobility: An Empirical Investigation", in *Money, Capital Mobility and Trade: Essays in Honor of Robert Mundell*, edited by G. Calvo, R. Dornbusch, and M. Obstfeld. (M.I.T. Press).

Hawkins, John and Dubravko Mihaljek. 2001. "The banking industry in the emerging market economies: competition, consolidation and systemic stability: an overview". In *The banking industry in the emerging market economies: competition, consolidation and systemic stability* Bank for International Settlements papers no. 4 (August).

Horstmann, Ignatius and James Markusen. "Firm-specific Assets and the Gains from Direct Foreign Investment". *Economica*, February 1989, 56 (221) pp.41-48.

Horvath, E. 2002. Lending booms, credit risk and the dynamic provisioning system, in *Studies on the Pro-cyclical Behaviour of Banks*, National Bank of Hungary Occasional Papers #10. <http://www.mnb.hu/english/>

Kiraly, Julia, Bea Majer, Lazlo Matyas, Bela Ocsi, Andras Sugar and Eva Varhegyi. 2000. "Experience with Internationalization of Financial Services Providers – Case Study: Hungary." In Stijn Claessens and Marion Jansen, eds *The Internationalization of Financial Services: Issues and Lessons for Developing Countries*. Boston, Mass.: Kluwer Academic Press.

Kokko, Ari, 1994. "Technology, Market Characteristics, and Spillovers," *Journal of Development Economics* vol. 43 pp.279-293.

LaPorta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer. 2002. "Government Ownership of Banks" *Journal of Finance*, forthcoming.

Levine, Ross. 1999. "Foreign Bank Entry and Capital Control Liberalization: Effects on Growth and Stability." Manuscript, University of Minnesota.

Lipsey. "Inward FDI and Economic Growth in Developing Countries," *Transnational Corporations*, Vol. 9, No. 1, April 2000, Geneva, United Nations Conference on Trade and Development, pp. 67-96.

Lipsey, Robert E. and Frederik Sjöholm. 2002. "Foreign Firms and Indonesian Manufacturing Wages: An Analysis with Panel Data". NBER working paper no. 9417 (December).

Mathieson, Donald J. and Jorge Roldas, 2001. "Foreign Banks in Emerging Markets". In Robert E. Litan, Paul Masson, and Michael Pomerleano, eds. *Open Doors: Foreign Participation in Financial Systems in Developing Countries*. Washington DC: Brookings Institute Press.

Martinez Peria, Maria Soledad, and Sergio Schmukler. 1999. "Do Depositors Punish Banks for 'Bad' Behavior? Market Discipline in Argentina, Chile, and Mexico." World Bank Policy Research Working Paper no. 2058, February.

Novaes and Sergio Werlang. "Political Risk and capital Structure choice of foreign subsidiaries: An Empirical Analysis" November 2001
<http://www.bis.org/pub/joint04.pdf>

Oman, C. 2000. *Policy Competition for Foreign Direct Investment: A Study of Competition Among Governments to Attract FDI*. Paris OECD.

Peek, Joe, and Eric Rosengren. 1997. "The International Transmission of Financial Shocks: The Case of Japan." *American Economic Review* 87, no. 4 (September): 495-505.

Peek, Joe, and Eric Rosengren. 2000. "The Role of Foreign Banks in Latin America." Manuscript.

Rojas-Suarez, Liliana. 2001. "Rating banks in emerging markets: What credit rating agencies should learn from financial indicators." Institute for International Economics working paper 01-6.

Romer, Paul. 1993. "Idea gaps and object gaps in economic development" *Journal of Monetary Economics* 32 pp. 543-573.

Sapienza, Paola. "Lending Incentives of State-Owned Banks" Northwestern University working paper. 2002.

Seth, Rama, Daniel E. Nolle, and Sunil K. Mohanty. 1998. "Do Banks Follow Their Customers Abroad?" *Financial Markets, Institutions, and Instruments* 7 (4): 1-25.

Stallings, Barbara and Rogerio Studart. 2001. "Financial Regulation and Supervision in Emerging Markets: The Experience of Latin America since the Tequila Crisis". CEPAL.

Ter Wengel. 1995. "International Trade in Banking Services," *Journal of International Money and Finance*, 14, 47-64.

UNCTAD. 2001. *World Investment Report 2001. Promoting Linkages*. (Switzerland: The United Nations)

Unite, Angelo and Michael Sullivan. 2001. "The Impact of Liberalization of Foreign Bank Entry on the Philippine Domestic Banking Market." Philippine Institute PASCN discussion paper 2001-08.

Van Rijckeghem, Caroline and Beatrice Weder. 2000. "Spillovers through Banking Centers: A Panel Data Analysis of Bank Flows" *Journal of International Money and Finance* (forthcoming).

Weller (2001) "The Supply of Credit by Multinational Banks in Developing and Transition Economies: Determinants and Effects". United Nations DESA Discussion Paper no. 16 <http://www.un.org/esa/esa01dp16.pdf>

Zhang, Kevin Honglin and James Markusen. 1999. "Vertical Multinational and Host-Country Characteristics". *Journal of Development Economics* 59: 233-252.