Financial Sector FDI in Asian Economies

Some stylized facts and observations

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Introduction

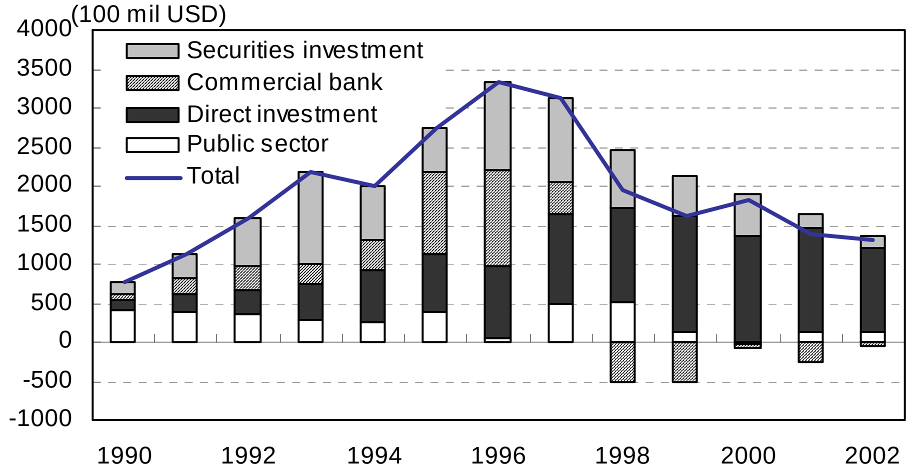
The purpose of this paper is to have a look at emerging economies in Asia and summarize stylized facts and observations concerning international capital flow in general and foreign direct investment (FDI) in the financial sector in particular, as well as foreign bank activities. The investment flow data from the Institute for International Finance (IIF), mergers and acquisitions (M&A) data from Thomson Financial, and BIS consolidate banking statistics are used to identify notable features of Asian economies. Whenever possible, comparison with other regions such as Latin America is shown as well. The readers are reminded, however, that because of the data limitations, all analyses should be regarded as "best effort" estimates and interpreted with due caution.

The remainder of the paper is organized as follows. In the first two sections, the characteristics of international capital flows towards Asian markets is compared with overall trend in the emerging markets. The third second section gives a look at historical perspectives and present a classification of Asian economies, which we believe is useful for understanding the roles of FDI in the financial sector in these countries. The final section uses M&A data to highlight recent trends in Asia and the difference between Latin America.

Overall features of capital flows to emerging countries

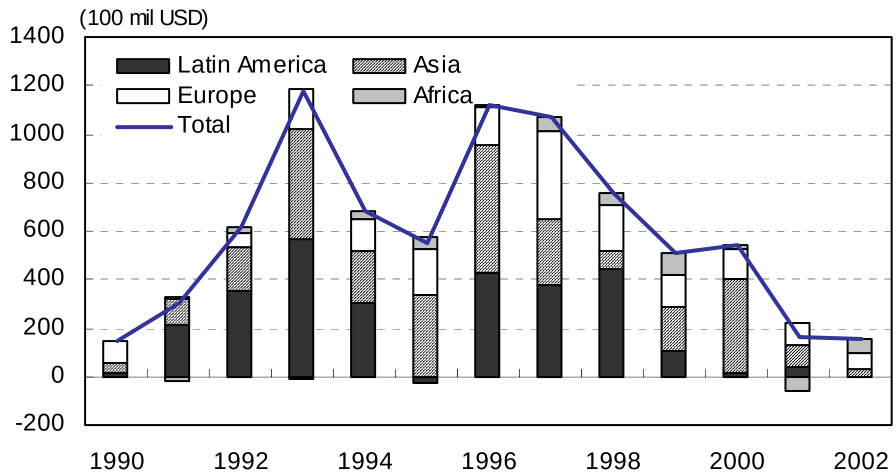
FDI has played an increasingly important role in the overall capital flow to emerging markets. It is partly due to the fact that securities investments and cross-border bank lending, which were both important sources of capital in emerging markets, declined significantly in the late 1990's. Compared with other forms of international capital flow, FDI has been a relatively stable source of capital for many Asia economies. In contrast, Securities investment towards emerging markets recorded its peak in the mid-90's and declined sharply after a series of crises (for example, Asian Crisis in 1997 and Russian Crisis in 1998). These crises prompted global investors to reevaluate the risk of investing in emerging markets and often led to their withdrawal from emerging markets.

(Table1) Capital flows to Emerging countries



(Source) IIF

(Table2) Securities investments to Emerging countries

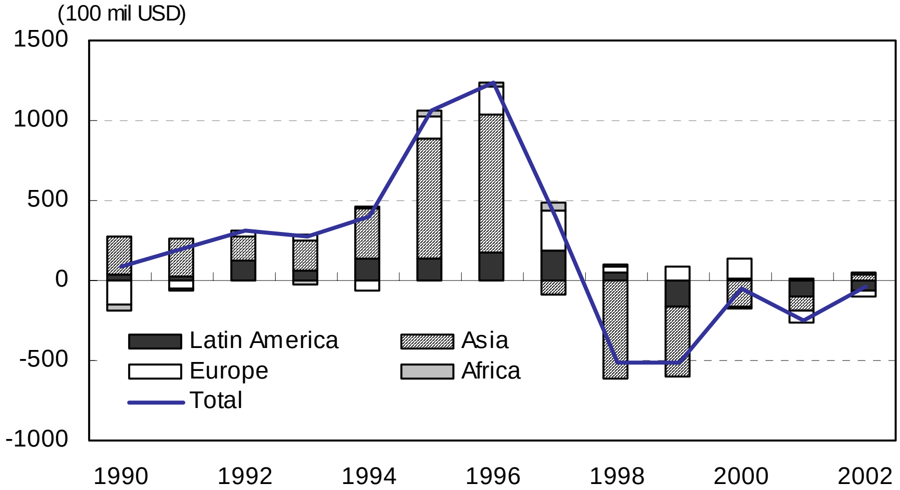


(Source) IIF

Lending by commercial banks around the globe to emerging markets has also shown large swings before and after the crises. According to the IIF statistics, capital inflows to the region from commercial banks have been recorded at more than 10 billion USD in 1995, and also in 1996, a year before the Asian Crisis. Capital flows reversed to net outflow in 1998. The most notable decline of cross-border claims occurred in Asia.

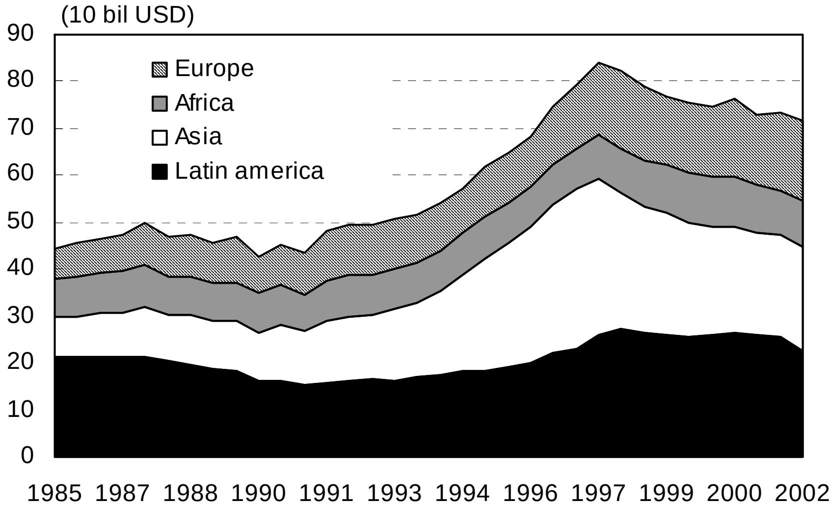
The BIS Consolidated Banking Statistics also confirm this trend. Cross-border claims (and local claims in foreign currency) of BIS reporting banks towards emerging countries started to decline in 1997.

(Table3) Bank lendings to Emerging countries



(Source) IIF

(Table 4) Cross-border lendings to Emerging countries



(Note) Including local claims in foreign currencies

(Source)BIS

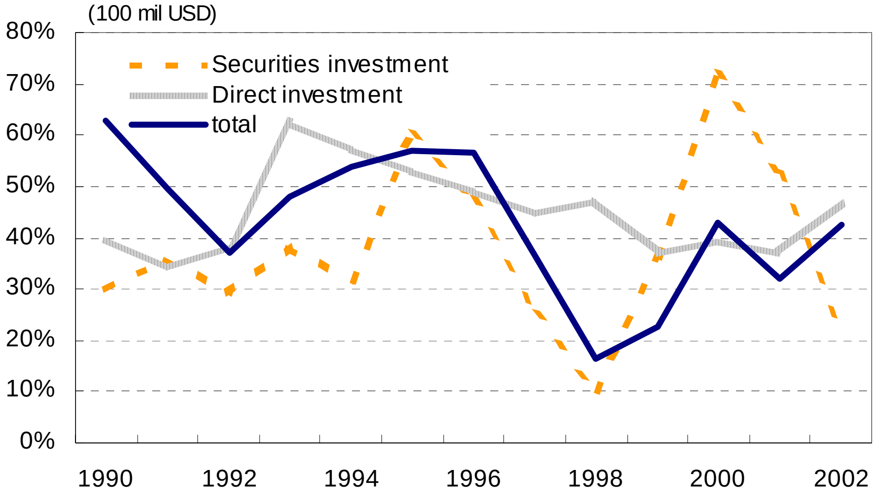
The decline of cross-border claims can partly be explained by improved risk management techniques at banks, and their reluctance to expose their balance sheets to risky assets. The increased presence of foreign banks in local markets may also have contributed to the decline in cross-border claims. Recently, foreign banks have expanded their claims in emerging markets in the form of local claims rather than cross-border claims, which have led to the decline of cross-border claims to these regions. This means that foreign banks play a more direct role in these local financial markets. The BIS Consolidated Banking Statistics also show that local claims of reporting these banks have grown rapidly in the late 90's especially in Latin America

Overall features of capital flows to Asian emerging countries

In the 90's, capital flow to Asia occupied a high share in the overall capital flows to emerging countries, partly due to large direct investment to China.

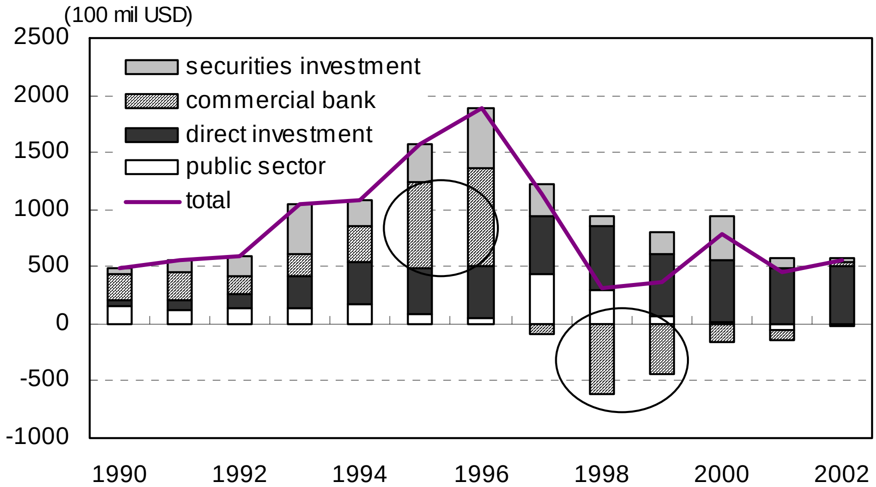
There are three main features for the capital flow to Asian emerging countries: 1) Commercial bank lending to Asia show large swing before and after the Asian Crisis, 2) Securities investment still play an important role as a source of capital to Asia, while the share of that to ASEAN countries has dropped significantly since the late 90's, 3) Direct investment to Asia has remained stable, but China enjoys the highest share in the region.

(Table4) Share of the flows towards Asia



(Source) IIF

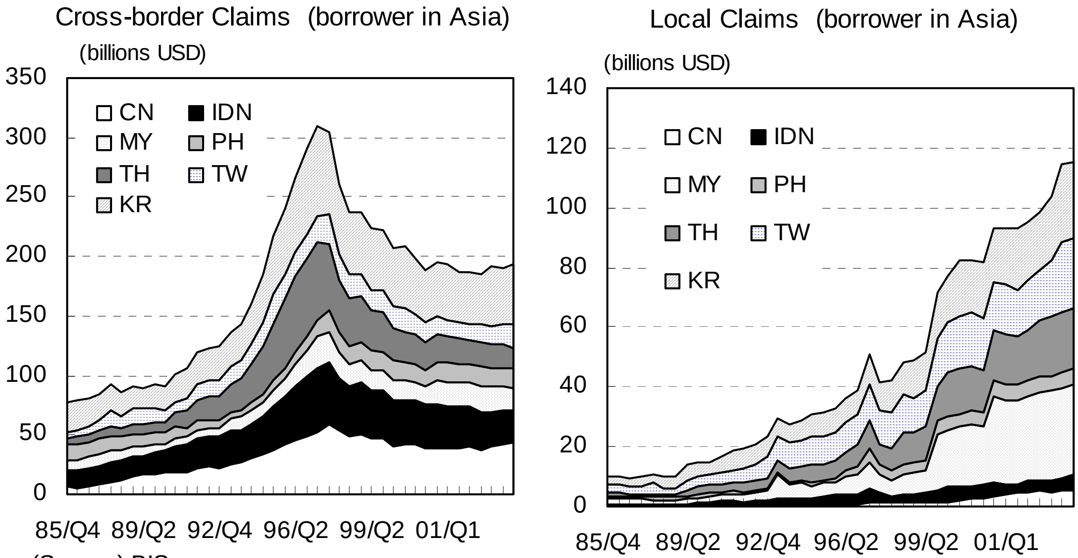
(Table 6) Capital flows towards Asian countries



(Source) IIF

Cross-border bank lending to Asian countries declined sharply after the Asian Crisis and has not recovered since then. While movements of cross-border claims have been volatile, the BIS Consolidated Banking Statistics show that local claims in local currency in Asia have increased steadily throughout the 90's and after. But the growth of local claims in Asia has not been as significant as in Latin America, which suggests that foreign bank entry was not so prominent in Asian countries in the late 90's compared to Latin America or Europe.

(Table 7) BIS reporting banks claims towards Asia

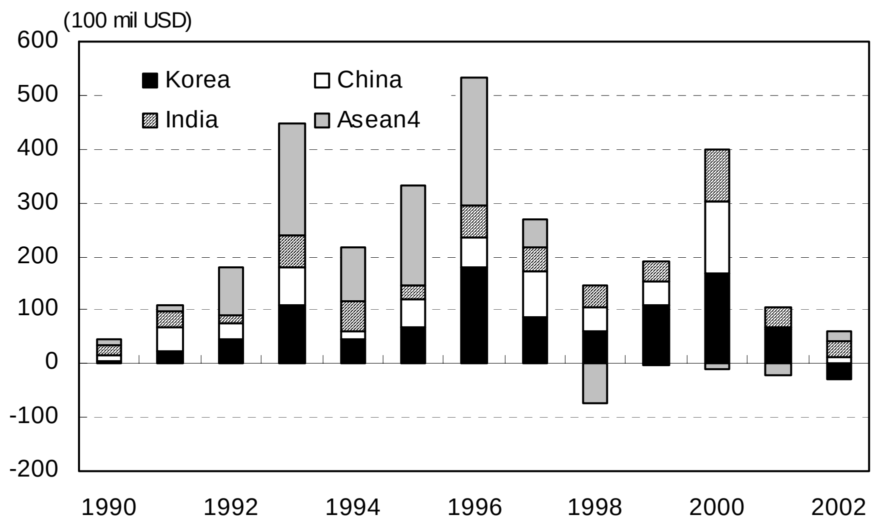


(Source) BIS

Securities investment to Asian countries showed the same trend as that for emerging countries overall, recording its peak in the mid-90's and declining significantly in the late-90's (with the notable exception of year 2000). It is worth noting that the share of ASEAN countries has dropped notably, partly because global investors tend to withdraw first from smaller emerging markets in limiting their exposure to risky assets.

In spite of the recent remarkable growth of the Chinese economy, securities investment towards China remains modest partly because of strict controls on the capital account.

(Table 8) Securities investments towards Asian countries

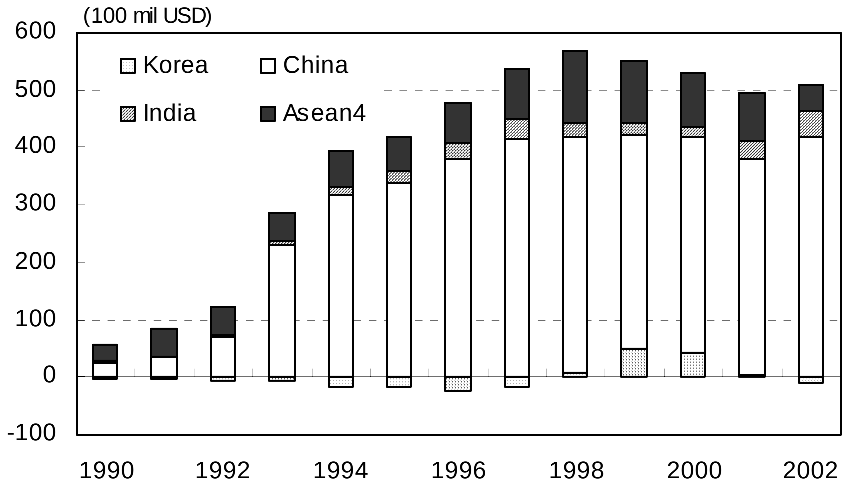


(Note) Asean4; Thailand,Indonesia,Malaysia, Philippine

(Source) IIF

IIF Statistics show that direct investment to Asian countries remained stable since the 90's (staying at approximately 50 billion USD), but it should be noted that China enjoys a high share (approximately 40 billion USD) while investments towards ASEAN countries seem to be on a gradual declining trend.

(Table 9) Direct investment towards Asian countries



(Source) IIF

Historical perspective on Asian financial markets

In comparing foreign bank activity in Asian countries with that of Latin America, it is important to note that there are large difference in financial market structure even among Asian countries. Foreign bank presence, reliance on FDI, and restrictions in financial markets vary among Asian countries. We categorize Asian economies into three categories: 1) Offshore financial centers (Hong Kong, Singapore), 2) Economies with relatively low reliance on FDIs (mainly East Asia), and 3) Economies with higher reliance on FDI (some ASEAN countries). These categories based on FDIs and foreign bank activities are not necessarily appropriate to capture the current situation in Asia, because the situation has changed remarkably in the recent years. Nevertheless, a historical retrospect is still important for deeper understanding of recent movements in Asian financial markets.

Category 1 economy is characterized by loose financial regulation to attract various foreign financial institutions. The financial sector, including foreign financial institutions, is core industry in such economies, and foreign bank presence in the financial markets is very high. These economies tend to have large financial markets, but the local retail financial markets tend to be relatively small. In the case of Singapore, foreign bank entry into local financial markets is limited.

Category 2 economy (East Asia, including Japan) is characterized by the concept of Catching up Product Cycle (CPC), which describes the gradual transition of industrialization in developing countries, i.e., from initial import to import substitution to export growth to maturing of local economy.

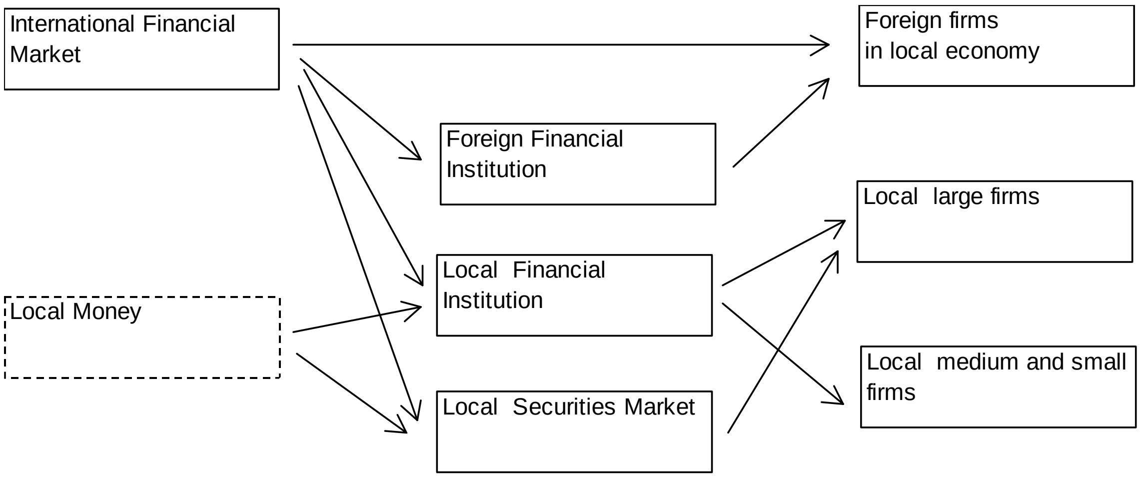
In this process, local corporations and financial institutions played a primary role, and reliance on the foreign direct investment was relatively low. Foreign banks played only a minor role, which translated to low foreign bank presence in the financial markets. In order to supply long-term and stable money to core industries at artificially low interest rates, which is often considered to be important preconditions for smooth industrial development, strict financial restrictions (such as regulation on interest or the business of financial institutions) were imposed. Public institutions held a large share in the financial sector of each country, and supplied stable money to strategic industries, which is called " Policy Money".

Compared to the category 2 economy, the category 3 economy can be described as economies with higher reliance on FDI. In ASEAN countries, such as Thailand or Malaysia, inviting foreign corporations to core industries enabled local industries to become highly competitive exporters. Local economies can speed up industrialization by utilizing FDI in this way.

Foreign corporations played an important role in industrial development, and this led to higher foreign banks presence in these economies as many foreign banks entered into the market in the form of "following the client". In such an economy, strict financial restrictions and "Policy Money" are not necessarily utilized for industrial advancement, because highly developed foreign corporations do not rely solely on the local financial market but can raise the necessary funds in the global financial markets at a favorable rate. Deregulated financial systems are more beneficial for these foreign corporations, so financial restriction in these countries are loosened at a relatively earlier stage of development. Most ASEAN countries have achieved significant financial deregulation in or before the early 90's in line with industrialization of their economies.

It should be noted, however, that such deregulation in these economies included the deregulation of interest, financial business, and capital account, but did not include the deregulation of FDI towards the banking sector. This is part of the reason why foreign bank presence in the local financial retail markets was limited before the Asian Crisis, though there have been notable changes in this situation after the Crisis.

(Table 10) Concept of category 3 economies



Foreign bank entries in Asia in the late 90's from the view of the cross-border M&A activities

The situation in Asia, low foreign bank presence especially in the retail markets, changed gradually after the Asian Crisis. After the Crisis, the governments in Asian countries started to loosen the restriction on financial sector FDI, in order to attract foreign capital and recapitalize the local financial system.

As was pointed out in the BIS CGFS WG meeting in November 2002, crises in general prompted foreign bank entries in emerging markets, as was confirmed in Asia. Financial sector FDI in Asia increased suddenly after the Crisis.

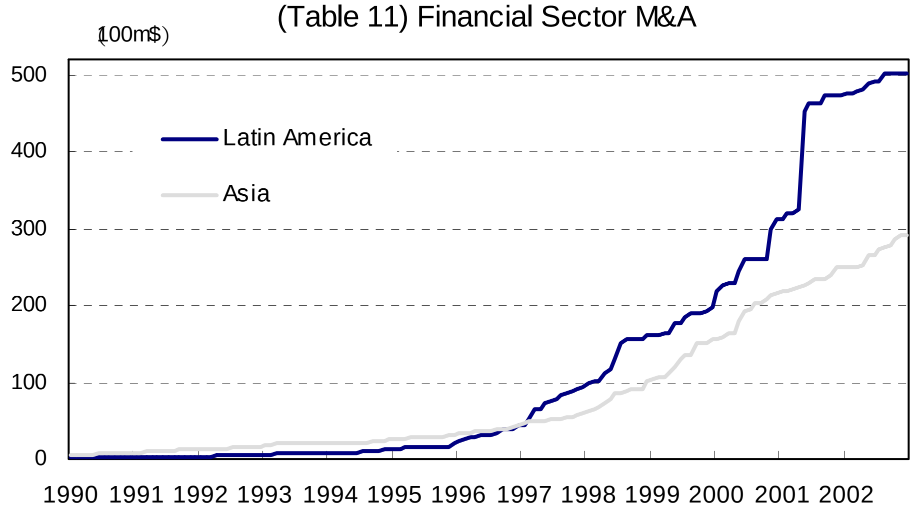
However there are significant differences in FDI, compared to the case in Latin America and Europe: 1) Scale of FDI is limited, 2) Foreign bank entries slowed after the initial surge, and 3) Banks are not necessarily major player.

Here, we described main features of financial sector FDI in Asia by using the financial sector M&A data as a proxy for FDI figures.

Compared to Lain America, the scale of financial sector FDI after the crisis is limited in Asia. Thomson Financial data-base figures show that cross-border M&A towards the financial sector has grown steadily both in Latin America and in Asia, but the pace of growth in Asia was far slower than in Latin America. In the last five years, cumulative amount of cross-border M&A to financial sector reached $41 billion in Latin America, while that of Asia is $23 billion. The average deal size in Asia was also far much smaller, which suggest there were few "Mega Deals" in Asia. In the last 5 years, average deal size amount to be $187 million in Latin America, and only $40 million in Asia.

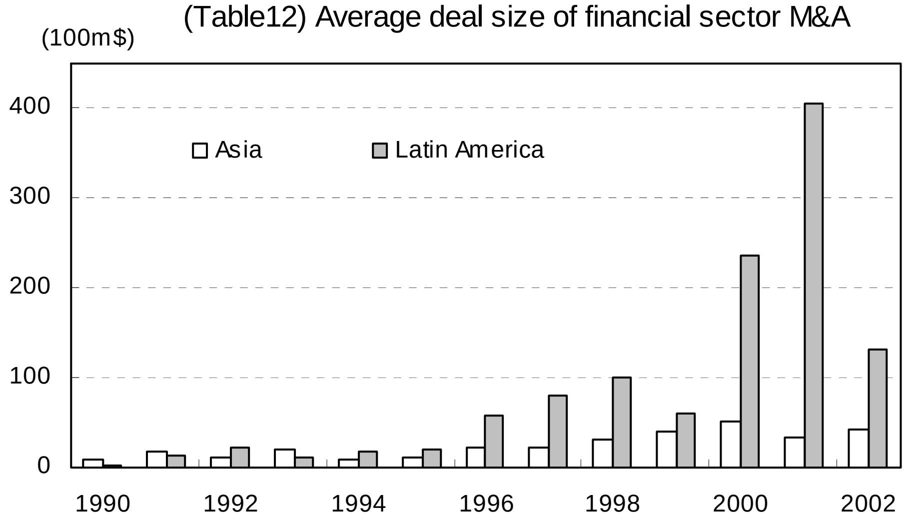
The still rigid restrictions, even after some lifting of restrictions, in Asia are one of the most apparent reasons for limited scale of FDI after the crisis. Regulation on financial sector FDI and foreign bank activities were somewhat loosened, but still limit such activities in most of Asian countries.

(Table 11) Financial Sector M&A



(Source) Thomson Financial

(Table12) Average deal size of financial sector M&A

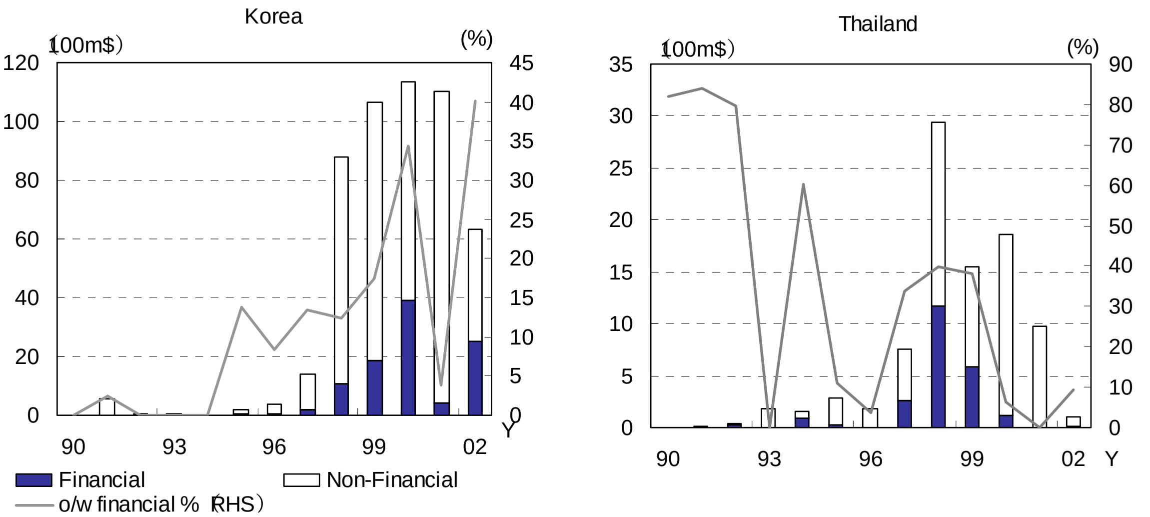


(Source) Thomson Financial

Significant slowdown of foreign bank entries after the initial rush is also a notable difference between Asia and Latin America. In Asia, large-scale foreign bank entries are observed only in Thailand and South Korea. Financial sector M&A surged after the Crisis in both countries, but both countries experienced a slow-down in M&A activity after the first series of entries.

Strong resistance to foreign ownership may be one of the reasons for this slow-down. In the case of Thailand, resistance to foreign ownership was refueled after the first series of foreign bank entries, which made the government reluctant to further sell failed local banks to foreign capital.

(Table 13) Cross-border M&A to Korea and Thailand



Comparison of Top 10 financial sector M&A deals in Asia and Latin America shows that there are major differences in the contents of FDI. In Asia, banks were not always major players in the M&A deals, while in Latin America, the top deals were dominated by global banks which acquired large local banks. M&A deals in Latin America were often considered as part of global banks' expanding strategies. The global banks acquired large local banks and made these their subsidiaries. Through these newly acquired local subsidiaries, they participated in local lending in local currencies, and effectively became permanent members of local markets. In contrast to the case in Latin America, securities firms and investment funds were major players in the M&A deals. This suggests that the purpose of M&A deals in Asia is primarily future capital gain and not as footholds to show their permanent commitments to local markets as in Latin America.

(Table 14) Top 10 deals of financial sector FDI in Latin America

Date	Value（$mil）	Target Name	Target Natior	Acquirer Name
05/17/01	12821.001	Banacci	Mexico	Citigroup Inc
11/20/00	3580.689	Banco do Estado de Sao Paulo	Brazil	Banco Santander Central Hispan
07/08/98	2100.000	Banco Real SA	Brazil	ABN-AMRO Holding NV
05/08/00	1542.645	Grupo Financiero Serfin SA de	Mexico	Banco Santander Central Hispan
06/12/00	1400.000	Grupo Financiero Bancomer SA	Mexico	Banco Bilbao Viz Argent{BBVA}
12/29/00	1161.764	Banco do Estado de Sao Paulo	Brazil	Banco Santander Central Hispan
08/21/02	1134.703	Grupo Financiero Bital SA	Mexico	HSBC Holdings PLC{HSBC}
09/14/01	1094.400	Grupo Financiero BBVA Bancomer	Mexico	Banco Bilbao Viz Argent{BBVA}
01/20/00	1000.000	Banco Bozano Simonsen SA	Brazil	Banco Santander Central Hispan
03/26/97	999.802	Banco Bamerindus do Brasil	Brazil	HSBC Hong Kong(HSBC Hldg PLC)

･･･Commercial Banks, Bank Holding Companies

(Table 15) Top 10 deals of financial sector FDI in Asia

Date	Value（$mil）	Target Name	Target Natior	Acquirer Name
36,314	847	Keppel TatLee Bank Ltd	Singapore	AIB Group
37,377	750	Woori Asset Management Co Ltd	South Korea	Lehman Brothers Holdings Inc
36,651	750	Fubon Securities,Fubon	Taiwan	Citigroup Inc
36,409	744	DBS Bank	Singapore	Brandes Investment Partners LP
37,201	643	DBS Group Holdings Ltd	Singapore	Investor Group
37,552	642	Chohung Bank-Credit Card Op	South Korea	General Electric Capital Corp
37,460	600	Ping An Insurance Co Ltd	China	HSBC Ins Hldgs Ltd
36,259	500	Kookmin Bank	South Korea	Goldman Sachs & Co
36,661	500	Chohung Bank	South Korea	Cerberus Capital Management LP
35,971	497	Financial Sector-Tranche ABCD	Thailand	General Electric Capital Corp
36,854	467	KEB Credit Card Service Co Ltd	South Korea	Citibank NA

･･･Commercial Banks, Bank Holding Companies

Conclusion

Among the several sources of capital flows, direct investment is the most stable source of capital towards Asian countries. While movements of cross–border banking claims towards Asian countries are very volatile before and after the Asian Crisis, foreign banks' local claims in local currencies have grown steadily, though the magnitude is not significant as the case in Latin America.

Asian countries tread different paths regarding their economic development, which led to divergent dependence of FDI and foreign bank presence in national economy. We can categorize these economies into three types; Off-shore centers, economies with low dependence of FDIs, and the economies with high dependence of FDIs.

Financial sector FDI has increased in Asia after the Asian Crisis, but there are major differences from the case in Latin America. In Asia, the scale of FDI is more limited, the slowdown occurred after the first series of investment, and banks are not always major players.