Foreign Participation in East Asia's Banking Sector

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Contribution to the CGFS Working Group on FDI in the Financial Sector of Emerging Market Economies, prepared by Jonathan Coppel and Michael Davies.

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1. Introduction

The purpose of this paper is to provide an overview of the magnitude, structure and forces shaping financial sector foreign direct investment (FDI) in the East Asian emerging market economies. Since some of the forces underpinning the structure of FDI in East Asia are unique, the paper provides an interesting case study and complements similar contributions from other CGFS Working Group participants covering the emerging market economies of Latin America and Eastern Europe. The paper places emphasis on foreign participation in the banking sector, rather than the standard, though arbitrary, 10 per cent equity ownership threshold needed to classify a stake as FDI. The paper is structured as follows. The next section reviews developments in the level and make-up of foreign participation in the banking sector and where appropriate, how these trends compare with other emerging market economies. To place these trends into perspective, the section starts with a brief overview of capital flows to East Asia over the past decade or so, and then reviews the main features of inward FDI, before presenting information on financial sector FDI and cross-border finance sector mergers and acquisitions. Given the emphasis on foreign bank activity, section 3 looks at key features of cross-border bank lending in the East Asian economies and how these have changed following the Asian crisis. Section 4 discusses the forces underpinning FDI in the finance sector, and is followed by a brief section on the impacts of financial sector FDI and policy issues. Finally, section 6 summarises the main findings.

2. Foreign Participation in the Banking Sector of East Asian Economies

A number of different data sources are used in this paper. They include the IMF, UNCTAD and ASEAN for statistics on FDI, Bankscope and the central banks of East Asia for information on bank balance sheets, Thompson Financial DataStream for data on mergers and acquisitions and the Bank for International Settlements (BIS) for cross-border lending data. In addition, section 4 uses a data set compiled by the Australian Productivity Commission to evaluate the prevalence of barriers to FDI in banking in East Asian countries and how they compare with other service sectors and economies. Despite the paper's focus on international comparisons, data limitations restrict in some areas scope for cross-country comparisons. For example, there is a lack of comparability of FDI data reported by countries, leading to discrepancies between total outflows and inflows and between outward and inwards stocks of FDI. There are two main causes for the discrepancies. First, not all countries comply with every aspect of the internationally recommended guidelines for compiling FDI data, and second, accounting practices and valuation methods differ between countries. There are as well particular problems relating to measurement of FDI in the finance sector. Specifically, the level of bank activity by local branches may bear little relationship to the assets owned by the parent banks, as FDI data sometimes mistakenly include the deposits made by a parent in its foreign affiliates. This can give rise to a substantial overestimation of FDI, as the motivation for such deposits may be a response to interest rate differentials, fiscal changes or political uncertainty, rather than foreign involvement in local banking operations. Similarly, the intra-company flows between affiliated entities engaged in financial intermediation should be excluded from FDI, though in practice this is not always the case. Furthermore, the method used to allocate FDI by industry tends to overstate the importance of FDI in the finance sector. This occurs because when a financial institution buys a stake or receives equity from a company in receivership, the sectoral allocation is based on the industry classification of the bidder or acquirer, rather than the target business. The magnitude of this bias is difficult to assess, but it is evident from cross-border mergers and acquisitions data that many acquired firms are in sectors other than finance. Finally, because the paper uses a number of different data sources, each constructed based on a variety of concepts and with different degrees of coverage, within country calculations are also not always comparable.

For the purposes of this paper, East Asia is defined as Indonesia, Korea, Malaysia, the Philippines and Thailand. These countries are grouped together because they lie within a geographic area and because they were the economies most affected by the Asian financial crisis in 1997 and 1998. Taken together, East Asia accounts for about 2¾ per cent of global GDP and almost 7 per cent of the world population. While the five countries share some common features, their economic structure and degrees of development differ considerably. GDP per capita ranges from around US$9,000 in Korea, to less than US$1,000 in Indonesia. Agriculture, a sector where FDI flows are limited, accounts for around 20 per cent or more of GDP in Indonesia and the Philippines, but only 8 per cent or less in the other economies. There are also, reflecting recent economic performance, large differences in national saving, capital formation, inflation and unemployment rates.

There are also substantial differences within the banking systems (Table 1). The degree of concentration, measured by the share of deposits held by the five largest banks spans a wide range, from 30 per cent in Malaysia to 75 per cent in Thailand. And there are sizeable differences in ownership structures. In Indonesia the government owns banks with nearly half total bank assets, partly reflecting the takeover by the Indonesian Bank Restructuring Agency of Indonesia's four largest commercial banks in 1999. Government ownership in the other East Asian countries is considerably lower, and broadly similar to emerging market economies in Latin America and Eastern Europe. In contrast, foreign ownership of the banking sector, based on the proportion of bank assets held by foreign banks, is substantially lower in East Asia, compared with Latin America and Eastern Europe. Consistent with the low foreign ownership and the presence of obstacles to FDI in banking in East Asia, is the relatively high refusal rate on applications for a foreign bank licence. Another distinguishing feature of East Asian bank structures is the large magnitude of bank assets as a proportion of GDP. This ratio is close to, or above 100 per cent in all the East Asian countries, compared with about half that level in most other countries in Latin America and Eastern Europe.

Table 1: Some Features of Bank Systems in Emerging Market Economies[1]

Country	Bank Assets (per cent of GDP)	5 Largest Banks' Share of Deposits (per cent)	Share of Bank Assets Owned by: Gov't (per cent)	Foreigners (per cent)	Index of Bank Restrictions[2]	Number of Foreign Bank Licences:[3] Requested	Denied
East Asia							
Korea	98.0	47.5	29.7	0.0	2.3	0	0
Thailand	117.0	74.8	30.7	7.2	2.3	0	0
Malaysia	166.0	30.0	0.0	18.0	2.5	0	0
Indonesia	101.0	52.9	44.0	7.0	3.5	5	3
Philippines	91.0	45.6	12.1	12.8	1.8	23	10
Latin America							
Argentina	54.0	48.0	30.0	49.0	1.8	8	0
Brazil	55.0	57.6	51.5	16.7	2.5	12	9
Chile	97.0	59.4	11.7	32.0	2.8	0	0
Mexico	30.0	80.0	25.0	19.9	3.0	0	0
Peru	36.0	81.2	2.5	40.4	2.0	1	0
Venezuela	6.0	63.8	4.9	33.7	2.5	3	1
Eastern Europe							
Czech Republic	125.0	74.0	19.0	26.0	2.0	0	0
Poland	54.0	57.2	43.7	26.4	2.5	12	0
Russia	16.0	80.0	68.0	9.0	2.0	0	0
Estonia	59.0	95.0	0.0	85.0	2.0	0	0
Bulgaria	20.4	63.0	17.6	73.3	--	3	0
Hungary	50.0	--	2.5	62.0	2.3	1	0
Slovakia	61.6	71.3	25.8	56.7	--	4	2

1. Data are shown for the latest year available, which are mainly 2001.
2. Index from Barth Caprio and Levine (2001). The index ranges between 0 and 4. The higher the index value, the more restrictive the country's banking sector.
3. Based on the number of applications over the previous five years.
Sources: IMF; World Bank

2.1 Trends in Capital Flows to East Asia

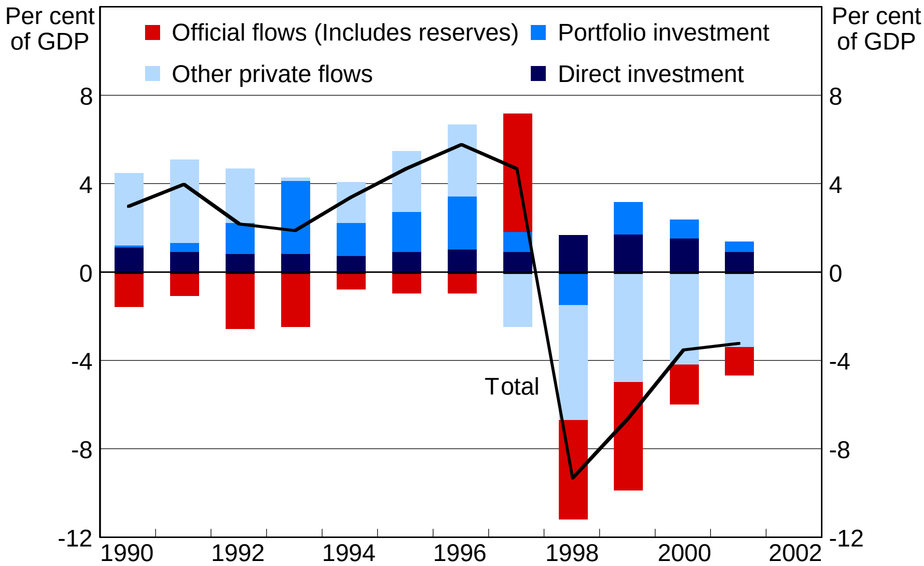
Aggregate movements in net capital flows to East Asia have broadly mirrored those of overall emerging market capital flows over the past decade or so. Through the first half of the 1990s net capital flows per annum remained fairly steady at between 4 and 5 per cent of GDP (Graph 1). These increased quite sharply in 1995 and 1996, as current account deficits widened in the East Asian economies, particularly in Thailand and Malaysia to reach a peak of some 6 per cent of GDP for the region. Over this period, the size of net FDI flows relative to GDP was broadly steady, at equivalent to about 1 per cent of GDP.[1] All of the increase in net capital flows in the mid-1990s was accounted for by higher portfolio investment and lending by banks and money markets (Other private flows). At the time of the financial crisis, portfolio and bank lending flows reversed sharply, primarily driven by large outflows of bank lending

1. Net and gross FDI flows in the East Asian economies are similar in magnitude, since outflows of FDI are minor, except for Korea.

(see also section 3). As the economies contracted, and the currency depreciations raised international competitiveness, current account positions quickly shifted from a deficit to a surplus, and have been for the region as a whole in surplus since 1998. Thus net capital flows have averaged about minus 2 per cent of GDP. Nonetheless, over the same period, net FDI flows, after a modest decline in the immediate aftermath of the crisis, rose sharply as a share of GDP to average 1½ per cent of GDP. Portfolio investment flows also recovered quickly.

Graph 1

Net Capital Flows of East Asian Countries



Source: IMF

One of the advantageous characteristics of FDI flows, also evident in East Asia, is their relative stability, although FDI can be associated with volatility, especially when foreign investors take positions in securities markets to hedge their exposures. Measures of volatility, such as the coefficient of variation, on the main forms of financial flows for the East Asian region over the past 12 years, show that FDI is the form least likely to be associated with capital flight and creditor panic. Another manifestation of this characteristic is the relatively steady FDI inflows to East Asia expressed as a share of gross fixed capital formation. Apart from the years following the crisis, when investment was particularly adversely affected, this ratio has consistently remained close to about 5 per cent over the past two decades.

2.2 FDI in the East Asian Economies

While FDI inflows to East Asia in aggregate have remained relatively stable as a share of GDP, there is variation in the magnitude and composition of FDI across the five East Asian countries. In terms of the size of FDI inflows, Korea is the largest recipient, and ranks fifth in overall emerging market flows.[2] Malaysia and Thailand follow, and are also among the top 10 emerging market economy recipients of FDI. In Thailand, FDI inflows almost doubled in the years following the crisis, but have since returned to around the pre-crisis levels, equivalent to about US$4 billion per annum. FDI inflows in the Philippines are currently less than half this level, but were less affected during the crisis and have displayed rapid growth over the past three years. Likewise, in Malaysia growth in inflows has been buoyant, though inflows are still below the pre-crisis levels. Indonesia is the only East Asian economy that has not experienced an increase in FDI inflows since the crisis. In fact, inflows fell sharply after the crisis and have been negative for the past 5 years, reflecting the volatile economic and political situation.

The geographic composition of FDI source countries and sectoral structure of FDI also differ considerably among the five East Asian economies, reflecting comparative advantages, natural resource endowments, and historical and geographic ties. Based on the stock of FDI, the finance sector accounts for the largest proportion of FDI in the Philippines and Malaysia (Table 2). The finance sector is also important in Korea, following petrochemical products and electrical equipment. As in other emerging market economies, the sectoral composition of FDI is concentrated. The top three sectors for FDI account for between 43 per cent (Philippines) and 54 per cent (Indonesia) of the total stock of FDI in these economies. Likewise, the composition of FDI source countries in East Asia is concentrated. The top three source countries account for between 48 and 63 per cent of total FDI, again with Indonesia and the Philippines at these extremes. The United States and Japan consistently feature among the main source countries across the East Asian economies. Apart from the Netherlands, the other major FDI source countries are Asian. While the US and Japan have a significant presence in all the East Asian countries, the proportion of their FDI investments in the region is small, at around 5 per cent (Japan) or below (US) of their overall FDI outflows. It is also noteworthy that despite a number of years of negative FDI inflows, Indonesia remains a major host, linked to the large degree of foreign investment in petrochemical and petroleum products.

Table 2: Key Features of FDI in East Asia in 2000

	Stock of FDI (US$b)	Main Sectors	Per cent of Total	Main Source Countries	Per cent of Total
Korea	42.3	Petrochemical Products Electrical Equipment Finance	45.2	United States Netherlands Japan	54.4
Thailand	27.9	Distributive Trade Real Estate Electrical Equipment	49.5	Japan United States Hong Kong	62.3
Malaysia	54.3	Finance Electrical Equipment Petroleum	48.9	Japan Taiwan United States	53.1
Indonesia	60.6	Metals and Metal Products Petrochemical Products Petroleum	54.1	Japan United States Hong Kong	47.6
Philippines	12.7	Finance Petrochemical Products Petroleum	43.2	United States Japan Netherlands	62.4

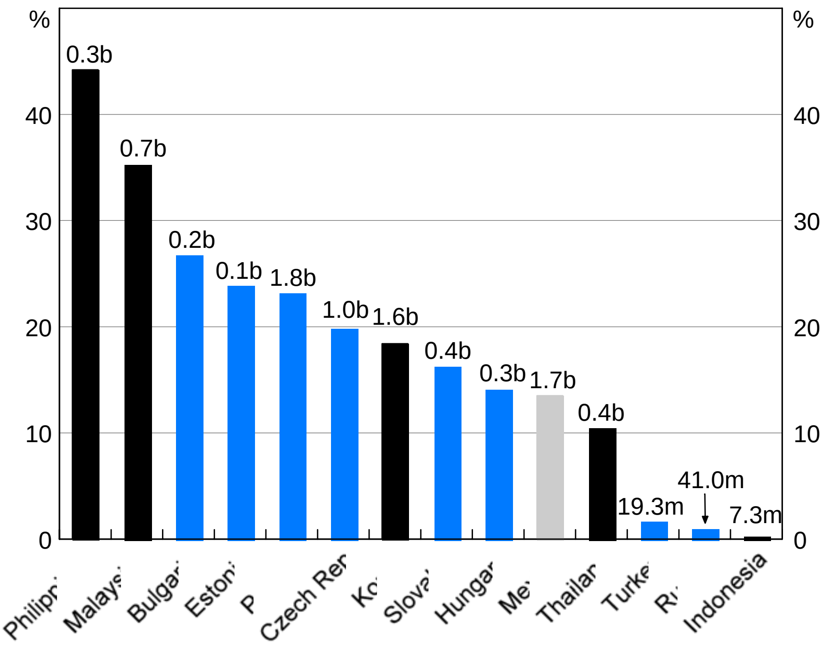
Sources: IMF; Thompson Financial DataStream

2. China, Mexico, Hong Kong, Singapore and Brazil are the other major destinations for FDI inflows.

2.3 Financial Sector FDI Flows in the East Asian Economies

The quick rebound in FDI inflows to all East Asian economies, except Indonesia is mostly attributed to the faster than expected recovery in the region, and it also appears to have been driven by financial market reforms that included the removal of barriers to FDI in the sector (see section 4). The response in terms of inflows of finance sector FDI has been swift, with substantial increases in all countries where data are available except Indonesia. The inflows have been particularly high in Korea, where FDI to the finance sector is now more than three fold higher than in the years prior to the crisis, averaging US$1.6 billion in the latest 3 years (Graph 2). And in Thailand the increase is by a considerably larger factor, such that by the late 1990s, a little more than 10 per cent of total Thai FDI inflows, almost equivalent to US$½ billion, were to the finance sector. In the Philippines the level of finance sector FDI inflows is low compared with the other East Asian economies, but the sector accounts for nearly half of total FDI inflows, which is considerably higher than in other emerging market economies in Asia, Latin America and Eastern Europe. Only in Indonesia have inflows of finance sector FDI, and that sector's share of total FDI fallen in the years following the Asian crisis. The legal form these FDI inflows take does not display a general pattern, and seems to be determined by local legislation, rather than a conscious choice by the head office. In the Philippines, Indonesia and Thailand, foreign operations are mostly through the establishment of branches, whereas in Malaysia, subsidiaries are more prevalent. In Korea, both subsidiaries and branches are used, with subsidiaries accounting for about 60 per cent of foreign bank assets in Korea.

Graph 2
Emerging Market Financial FDI Inflows*



* Share of financial FDI in total inflows over the latest 3 years of data, which is typically 1998 to 2000. Malaysian data refers to the period 1993-1995. Values of financial FDI are expressed in $US billion (b) or US$ millions (m).

Sources: ASEAN; Bloomberg; OECD; UNCTAD

The geographic distribution of financial sector FDI source countries is highly concentrated. Nearly 85 per cent of inflows to East Asia over the past three years came from the US and the European Union. This is a significantly higher degree of concentration than for overall FDI inflows where slightly more than half of East Asian inflows are sourced from the US and the EU (Table 3). Japan has traditionally been a major investor in the region, however, over recent years it has divested from East Asia's finance sector, withdrawing investments valued at the equivalent of nearly US$½ billion per annum. Despite Australia's geographic proximity, Australian banks have only minor stakes in the banking sectors of East Asia's economies (see Box A).

Table 3: Geographic Distribution of East Asia's FDI Flows (1999-2001)

	Per cent of Average FDI Inflows				Average FDI Flows (US$b)
	Japan	United States	European Union	Rest of the World	
Korea					
Finance	--	--	--	--	1.8
Total	9.3	17.6	38.8	34.3	7.3
Thailand					
Finance	13.8	2.9	76.0	7.3	0.1
Total	20.7	9.9	15.6	53.8	4.4
Malaysia					
Finance	--	--	--	--	--
Total	4.9	56.6	32.6	5.9	2.7
Indonesia					
Finance	287.5	17.3	-217.7	12.8	0.0
Total	37.4	17.8	24.9	20.0	-3.5
Philippines					
Finance	3.6[2]	47.7	5.5	43.2	0.1
Total	7.0	34.9	20.5	37.7	1.5
East Asia					
Finance[1]	-20.6	34.9	52.2	33.6	2.0
Total	4.1	25.6	30.9	39.4	12.4

[1] Thailand, Indonesia and the Philippines [2] 1999.
Sources: IMF; ASEAN

Box A: Australia's FDI in East Asia's Financial Sector

Australia accounts for about 1¼ per cent of the global stock of FDI, broadly similar to its proportion of world output, and ranks 14th in terms of the value of its FDI abroad. The geographic distribution of Australia's FDI abroad is highly concentrated, with more than three quarters of the total located in the US, UK and New Zealand. In contrast, and despite the relative geographic proximity, the five East Asian economies considered in this paper account for less than 1 per cent of Australia's stock of FDI abroad, equivalent to around A$1¼ billion. However, the proportion of Australia's FDI in East Asia is increasing, evident by the higher growth in Australia's FDI flows to these economies than the overall average.

Approximately one quarter of Australia's FDI stock abroad is invested in the finance industry. Of this amount it is not possible to identify what proportion is located in East Asian countries, as confidentiality requirements prevent a comprehensive publication of official FDI statistics by industry and country. However, on the basis of bank annual reports and data on cross-border merger and acquisition activity, it is apparent that Australia's financial institutions have very small stakes in East Asia's financial sector (see table below). The four major Australian banks, which hold nearly 85 per cent of the total value of assets of all the Australian-owned banks, account for less than 1 per cent of bank assets in the East Asia region. This is considerably lower than in the early 1990s when Australia's major banks held about 3 ½ per cent of East Asia's bank assets.

Australia's Bank Assets in East Asia's Finance Sector

Bank	**1993**	**1996**	**1999**	**2002**
ANZ				
- Assets (A$b)	5.0	9.2	5.9	7.4
- Per cent of bank's assets	5.0	7.2	4.0	4.0
Commonwealth				
- Assets (A$b)	1.8	2.1	1.0	--
- Per cent of bank's assets	2.0	1.9	0.7	--
National				
- Assets (A$b)	6.4	6.6	3.0	3.9
- Per cent of bank's assets	5.5	3.8	1.8	1.7
Westpac				
- Assets (A$b)	9.4	4.6	2.4	--
- Per cent of bank's assets	8.9	3.8	1.7	--
Total, major four banks				
- Assets (A$b)	22.6	22.5	12.4	11.3
- Per cent of bank's assets	6.5	5.0	2.8	3.2
- Per cent of region's bank assets	3.4	2.3	1.1	0.7

Sources: IMF; Company Annual Reports

The ANZ bank has the largest investment stake in East Asia, accounting for nearly half the Australian bank assets in the region. The ANZ bank, like other Australian banks, reduced the scale of its investments in East Asia from around the mid 1990s, primarily to lower risk exposure. In recent years, however, there has been some renewed acquisition activity by Australian banks in East Asia, particularly in Indonesia. For instance, the Commonwealth Bank in mid 2000 paid US$8.4 million for a fifty per cent stake in PT Bank Commonwealth, lifting its stake to 100 per cent. Much of the acquisition activity in East Asia has been pursued by the ANZ bank. For instance, it purchased almost 10 per cent in PT Panin Bank Indonesia in late 1999 for US$30 million, acquired a credit card operations business and established a consumer-banking venture in the Philippines and is reportedly interested in acquiring a 10 to 20 per cent stake in the Thai Military Bank.

2.4 Cross-Border Financial Sector Mergers and Acquisitions in East Asia

One of the main components of financial sector FDI is cross-border finance sector merger and acquisitions (M&A), since foreign ownership is usually established through the partial or full purchase of existing enterprises, rather than greenfield investment (new projects). For this reason, it is common that analyses of financial FDI focus on M&A activity.[3] M&A activity data, however, use different sources and methodologies from official FDI statistics and consequently cannot be directly compared, although they display broadly similar trends. FDI data refer to funds channelled through the capital account of a country to businesses in the host economy where the foreign enterprise owns 10 per cent of the equity, or voting power in the enterprise. These transferred funds can either be, equity, reinvested earnings, or intercompany debt and are recorded when the asset actually changes ownership. In contrast, cross-border M&A data are compiled based on different concepts, capturing the value of transactions on the announcement date and including amounts that are not components of the balance of payments reporting of FDI data. If, for example, the foreign acquiring company raises debt within the domestic market to purchase the target company, that amount is included in the reported M&A value, but not in the FDI data. Moreover, M&A data place less emphasis on effective control, including all purchased stakes above 5 per cent, with the acquisition or disposal of lower stakes sometimes included when these amounts are considered to be of strategic importance. The two major providers of data on M&A are Thompson Financial DataStream and Dealogic. Both data sources indicate similar trends, although the timing of transactions tends to differ, influencing the profile of M&A activity.

Compared with other emerging markets, both the proportion of cross-border M&As in East Asia's finance sector and their value is small. Over the past decade or so, less than 20 per cent of all M&As were cross-border, worth the equivalent of some US$6½ billion. This contrasts with just over 50 per cent in South America and Eastern Europe, worth the equivalent of US$18 and US$12 billion respectively. The only other region with a smaller level and proportion of cross-border M&A activity in the finance sector is Africa and the Middle East (Table 4). East Asia, however, has been one of the fastest growing target regions for M&A, with a sizeable jump in cross-border M&A activity after the crisis, especially in Korea and Thailand. Another notable feature of the data, and in line with the trend towards closer economic integration in the region, is the large number of cross-border M&A transactions in the finance sector between the five East Asian economies, though these transactions are typically low in value (Graph 3).

3. See Focarelli and Pozzolo (2001) for a comprehensive analysis of cross border bank mergers and acquisitions.

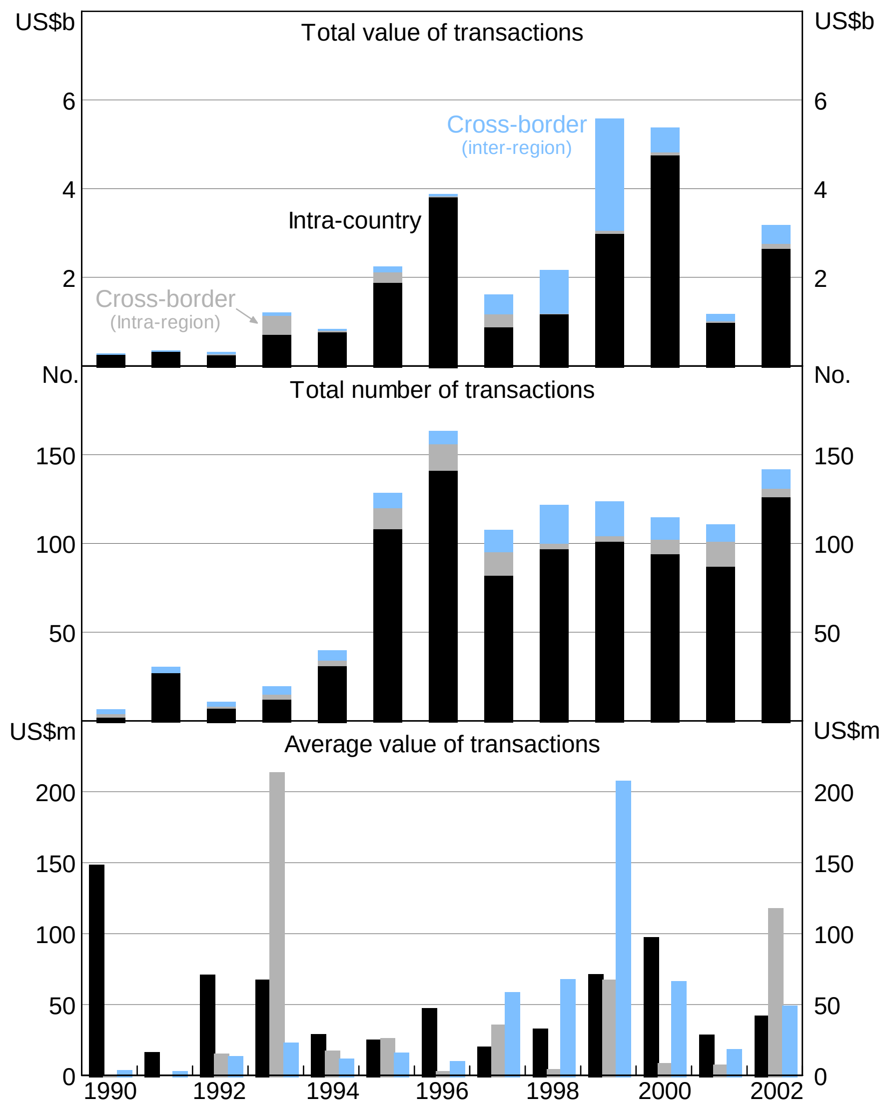
Table 4: Emerging Economy Finance Sector Mergers and Acquisitions (1990-2002)

	Number of Transactions		Value of Transactions	
	Total	Per cent that are cross-border	Total (US$b)	Per cent that are cross-border
Korea	85	27.1	7.1	29.8
Thailand	124	35.5	3.9	64.9
Malaysia	727	7.3	12.0	8.4
Indonesia	99	39.4	1.2	29.9
Philippines	89	41.6	4.2	10.8
East Asia	**1124**	**17.4**	**28.4**	**22.8**
Memo items:				
Rest of Asia	778	33.4	37.1	48.7
South America	394	55.3	29.5	51.7
Eastern Europe	586	52.6	13.6	85.9
Africa/Mid-East	373	30.0	27.8	20.6
All Emerging Markets	**3436**	**34.7**	**180.3**	**41.8**

Source: Thompson Financial DataStream

Graph 3

Financial Sector Mergers and Acquisitions in East Asia



Source: Thomson Financial Datastream

Unlike Latin America and Eastern Europe, cross-border M&A activity in East Asia has been largely through sales of private firms, with most of the activity since the crisis concentrated in the distressed sectors, including the finance sector. In Thailand, for example, the finance sector registered the largest number of deals in the two years following the crisis. This suggests that cross-border M&A activity is playing a role in the process of corporate and financial restructuring by improving the efficiency of operations as well as by reducing excess capacity. However, M&A activity is not just serving to resolve past problems, as many deals have been inspired by strategic partnerships designed to take advantage of the prospect of EU enlargement. Another possible factor is anti-trust policies in advanced economies, which may be limiting scope for expansion via domestic M&A. Even though less significant than in Eastern Europe, privatisations have also driven M&A activity in East Asia as governments have sought to reduce their stakes in the banking institutions which they took over and recapitalised in the wake of the financial crisis. Privatisation is likely to remain a spur to future M&A activity, since efforts to date have been hampered by problems assessing asset quality and uncertainty surrounding the allocation of possible future liabilities. Such concerns make it difficult for acquirers to evaluate the underlying value of the business and have been cited as factors delaying the sale of nationalised banks in Thailand and Korea.

While much M&A activity has been underpinned by the process of restructuring since the crisis, this avenue for adjustment would not have been as effective without concomitant regulatory reforms, which have reduced barriers limiting foreign ownership and commercial presence (discussed further in section 4). The reforms helped to underpin a particularly sharp rise in cross-border finance sector M&A transactions in Korea and Thailand in the years following the Asia crisis. Yet, even in Malaysia where cross-border financial sector M&A have been restricted by regulatory barriers, ownership change and consolidation has been considerable, albeit between domestic owners. Indeed, over the past 5 years more than ½ of the number of M&A deals in East Asia were in Malaysia, worth in aggregate US$5 billion. Of this amount only US$170 million involved a foreign player.

2.5 Financial Sector FDI Stock in the East Asian Economies

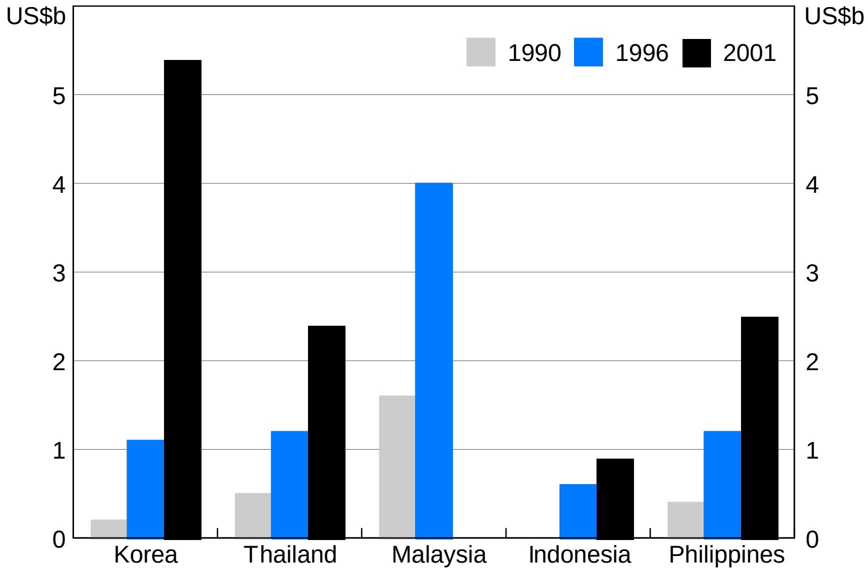
In line with the upward trend in finance sector FDI inflows and cross border M&A activity, the stock of financial sector FDI in all the East Asian economies where data are available has risen sharply over the past decade (Graph 4). Again the Asian financial crisis appears to have been the catalyst for a major upward shift in finance sector FDI, with most of the increase in the stock of FDI occurring in the past 5 years.[4] Korea, which had the lowest stock of financial FDI in 1990 has recorded the sharpest increase, rising by a factor of 20 to reach about US$5½ billion, equivalent to 1¼ per cent of GDP. Similarly, there have been big rises in Thailand and the Philippines to around 2 and 3¼ per cent of GDP respectively. On the

4. Part of the rise in the stock of finance FDI is likely to reflect the rising valuations of those finance companies with

other hand, reflecting the negative FDI inflows in Indonesia, the stock of financial sector FDI has remained broadly unchanged. In Malaysia, no up to date information is available on the value of financial sector FDI, though it is likely to have remained broadly unchanged since the crisis, reflecting Malaysia's policies designed to limit foreign ownership. These levels of finance sector FDI stocks are higher than those in Eastern European economies, but relative to GDP are generally smaller.

Graph 4

Stock of Financial FDI in East Asia



Sources: CEIC; UNCTAD; ASEAN

Alternative measures of foreign participation in the banking sectors of East Asian countries also suggest a low degree of foreign control. For instance, according to data from Bankscope, banks where foreigners own more than 50 per cent of total equity accounted for only 6 per cent of total bank assets in Korea, Malaysia and Thailand at the end of 1999. This compares with nearly one third in Latin America and almost two thirds in Eastern Europe. This measure, like the stock of financial sector FDI, has also risen rapidly, particularly in Korea and Indonesia.[5] Five years earlier the proportion was less than 2 per cent. Nonetheless, not too much weight should be attached to the level of foreign ownership, as it is sensitive to how it is defined. For instance, if the threshold of equity owned by foreigners that is considered to give control over management is set at 40 per cent, foreign ownership in East Asia more than doubles. Moreover, if the yardstick for measuring foreign participation is the number of foreign banks, another perspective emerges. In Malaysia and the Philippines the number of foreign banks is about equal to the number of local banks, and in Thailand in 2001 there were twice as many foreign banks than local banks, compared with broadly similar numbers a decade ago (Graph 5). Furthermore, the market share of foreign banks, measured as the proportion

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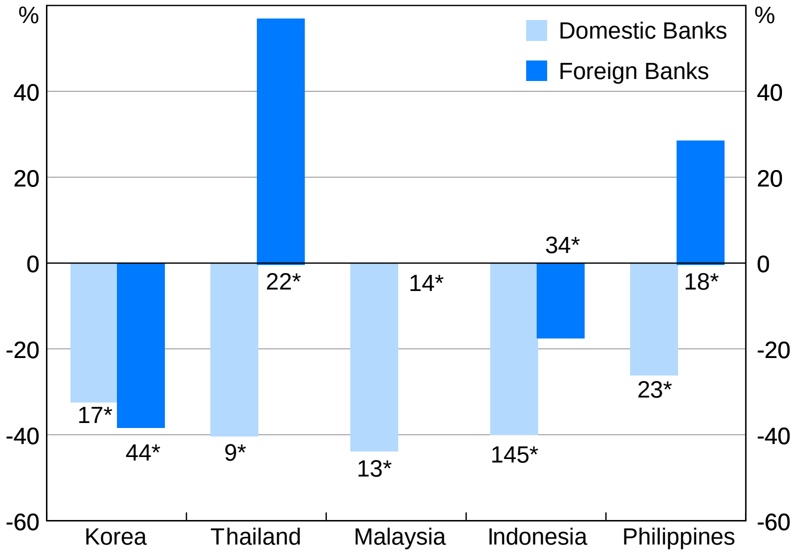
FDI investments.

5. See Kim (2003) for a detailed investigation of the trend toward greater foreign involvement in Korea's banking sector.

of total banking assets held by foreign banks has risen over the past decade in all East Asian countries, except Malaysia, where market share is relatively high, at around 25 per cent. However, compared with 20 or 30 years ago, foreign bank market share in Malaysia has declined substantially, as limitations on foreign banks opening new branches, installing automatic teller machines and caps on foreign shareholdings have limited their ability to grow.

Graph 5
Changing Composition of Bank Ownership in East Asia



* The per cent change in the number of domestic and foreign owned banks between 1995 and 2001. The numeric labels refer to the number of banks in 2001.

Source: Central Banks of East Asia

3. Key Features of Cross-Border Bank Lending in the East Asian Economies

International capital flows are a major source of finance and have traditionally been the most common foreign bank activity in emerging market economies with convertible capital accounts. However, cross-border lending is not usually associated with FDI. To be connected with FDI depends on whether the loan is provided by a domestic or foreign supplier established in the country through a commercial presence (e.g. branch, subsidiary, agency or joint venture). A loan involving international capital provided by a domestically owned bank will be recorded as cross-border lending, but does not require or include any FDI flows. If, however, a cross-border loan is provided through a foreign supplier established in the country, it is recorded as cross-border lending, impacts on the level of financial services trade and at some point, required FDI to establish the commercial presence. Given the importance of cross-border lending channelled through foreign owned banks in emerging market economies, this section of the paper focuses on the trends over the past decade in East Asia, some of their key features, how they compare with other major emerging market regions and with other forms of lending. In particular, the pre- and post-Asian financial crisis periods receive scrutiny, as the crisis was a catalyst for a number of financial market policy reforms that are likely to have lead to a re-evaluation of, and changes in bank lending behaviour.

Accordingly, the main disaggregation of lending is into cross-border lending (i.e. lending by overseas based banks) and domestic lending (i.e. lending by domestically based commercial banks). Domestic lending has been further divided into lending by local commercial banks and locally based foreign commercial banks. The objective of this disaggregation is to identify features of bank lending behaviour that differentiate foreign owned from domestically owned banks, and whether these characteristics have changed in recent years. The main information source used for cross-border lending is the Bank for International Settlements (BIS), and data for domestic lending in emerging markets are sourced from the IMF. Total bank lending is calculated as the sum of lending by domestic banks and cross-border lending. This is likely to overstate the size of the banking sector, since a proportion of cross-border lending is directed towards the local banking sector.

Table 5: Bank Lending In Emerging Markets

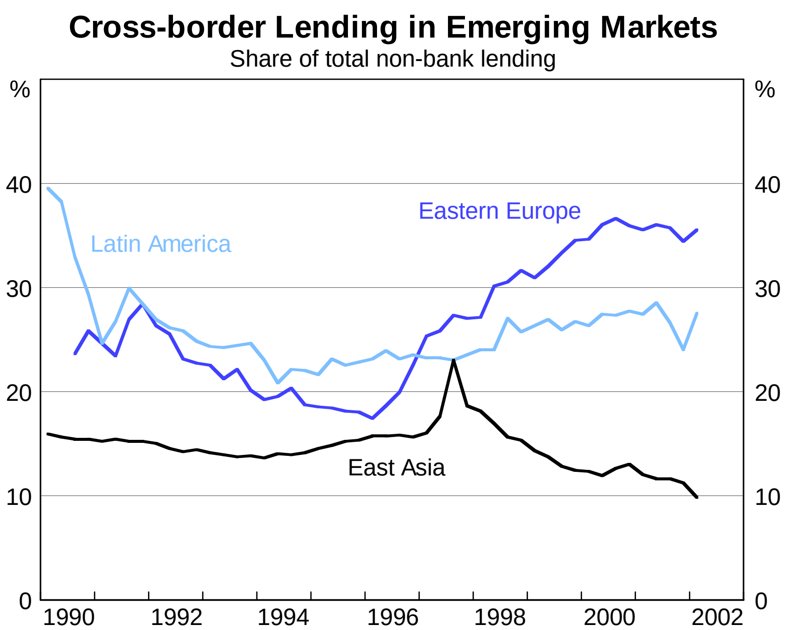
	Total Lending (1996)	**Average Annual Growth (1990-1996)**	**Total Lending (2002)**	**Average Annual Growth (1997-2002)**
	US$b	Per cent	US$b	Per cent
East Asia				
- Domestic Banks	769.5	18.1	876.1	2.4
- Overseas Banks^	247.2	18.6	193.6	-4.3
- Total	1016.6	18.2	1069.7	0.9
Latin America				
- Domestic Banks	563.7	17.3	484.8	-2.7
- Overseas Banks^	264.5	5.7	438.8	9.6
- Total	828.1	12.4	923.6	2.0
Eastern Europe				
- Domestic Banks	242.5	9.4*	252.8	0.8
- Overseas Banks^	136.8	7.6*	271.1	13.2
- Total	379.3	8.7*	523.9	6.0
All Emerging Markets				
- Domestic Banks	1575.7	12.7*	1613.7	0.4
- Overseas Banks^	648.4	10.1*	903.5	6.2
- Total	2224.0	11.9*	2517.2	2.3

^ Overseas banks include cross-border lending and lending by locally based foreign banks.
Sources: BIS; IMF. *Average of 1991-1996.

In line with the trends in net capital flows throughout the 1990s, cross-border lending and lending by locally based foreign banks were important sources of finance in emerging market economies. Between 1991 and 1996 such lending in Latin America, Eastern Europe and East Asia combined, rose at an average annual rate of around 10 per cent, to reach US$648 billion (Table 5). East Asia was a major contributor to growth in cross-border bank lending to emerging markets, especially in the first part of the 1990s. Indeed, the rate of growth over the period was considerably faster in East Asia, at around 19 per cent per annum, than in other emerging market regions. Moreover, East Asia was the only emerging market region where cross-border lending and lending by locally based foreign banks grew at a similar rate as lending by domestic banks. As a result of these trends, East Asia's share of aggregate lending to emerging market economies rose quickly, to account for 46 per cent of the total in 1996.

Despite these trends, a feature that distinguishes East Asia from other emerging market regions is the low share of cross-border lending in total non-financial sector lending. Cross-border lending in East Asia in mid 2002 accounted for about 10 per cent of total non-financial sector lending, whereas in Latin America and Eastern Europe it was closer to one third. Moreover, while this share has risen gradually in other emerging market regions over the past decade or so, it has declined in East Asia (Graph 6). Another notable feature is the low degree of correlation in cross-border lending between East Asia and other emerging market regions over the past 15 years, and especially since the Asian crisis. In contrast, cross-border lending flows between Latin America and Eastern Europe generally tend to move in tandem.

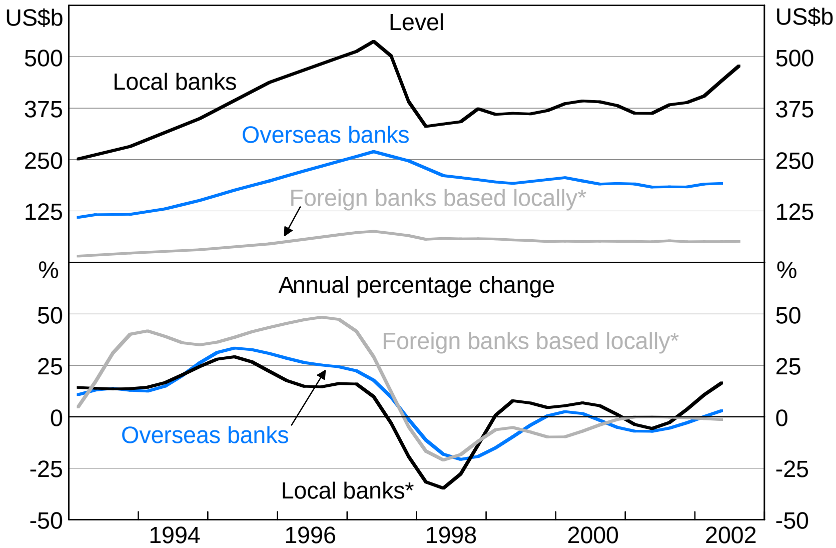
Graph 6



Sources: IMF; BIS

A number of features characterised the increase in East Asia's cross-border lending and lending by locally based foreign banks in the first part of the 1990s. First, cross-border lending was concentrated in short-term debt with maturity of less than 2 years. The share of these liabilities in the total stock of international bank claims against the region rose sharply to around 75 per cent by 1996, thereby considerably shortening the maturity profile of East Asia's liabilities. Second, the demand for corporate borrowing was strong and met by increased lending by domestic banks, funded through a combination of deposits and inter-bank loans, and greater cross-border loans to the corporate sector.[6] Third, while local banks drove most of the increase in total loan assets, with their loan assets almost tripling to over US$500 billion over the period, lending by locally based foreign banks recorded the fastest growth (Graph 7). Korea is the East Asian country that contributed most to the rise in cross-border lending and lending by locally based foreign banks, where such lending accounted for about ½ of the growth in total loan assets, with flows equivalent to about 3 per cent of GDP. Cross-border lending was also significant in Thailand and Indonesia, accounting respectively for 36 and 28 per cent of the increase in total loans (Table 6). These two countries also recorded the largest percentage increase in total loan assets over the period. In contrast, in Malaysia and the Philippines, domestically based banks accounted for most of the growth in total loan assets, with cross-border lending relatively unimportant.

Graph 7
Bank Lending in East Asia



Sources: BIS; CEIC. * Data prior to 1996 are estimates.

From around mid-1997, a general reassessment of future economic growth prospects in emerging market economies and concerns about the underlying robustness of financial systems led to a sharp and substantial contraction in bank lending. This was particularly marked in East Asia, where bank lending fell by 30 per cent in less than 6 months, the first annual decline in bank lending for the region. Thailand and Indonesia were most affected, with total loan assets falling by 39 and 27 per cent respectively between their peak in 1997 and end 1998. A sizeable proportion of these falls in US dollar terms was driven by local banks, though in part this reflected the impact of the sharp currency devaluations, since local banks had a higher proportion of their loan assets denominated in local currencies. Cross-border and lending by locally based foreign banks also declined, but by a smaller amount.

6. The disaggregation of cross-border lending by sector and maturity is based on consolidated claims data, rather than lending data and thus not strictly comparable with domestic bank lending.

Table 6: Bank Claims Against East Asia by Country

US$ billion

	Dec 1990	Dec 1993	Dec 1996	Dec 1999	Sep 2002
Korea	**102.1**	**127.8**	**203.4**	**237.9**	**371.5***
- Local banks	66.9	86.2	115.2	167.8	290.9
- Foreign banks based locally	6.9	6.4	9.9	6.9	7.5
- Cross-border	28.3	35.2	78.3	63.2	73.1*
Thailand	**57.7**	**111.1**	**218.3**	**144.1**	**108.2***
- Local banks	40.7	73.7	122.6	86.3	64.8
- Foreign banks based locally	2.4	6.1	23.6	16.5	11.3
- Cross-border	14.6	31.3	72.1	41.3	32.1*
Malaysia	**38.5**	**60.9**	**113.4**	**109.8**	**125.1***
- Local banks	--	--	66.4	57.0	66.2
- Foreign banks based locally	--	--	19.9	17.9	22.1
- Cross-border	8.6	15.3	27.1	34.9	36.8*
Indonesia	**81.6**	**112.4**	**178.7**	**75.1**	**69.7***
- Local banks	--	74.7	112.7	24.4	31.2
- Foreign banks based locally	--	7.6	11.7	7.0	6.9
- Cross-border	23.9	30.1	54.3	43.7	31.6*
The Philippines	**19.5**	**24.5**	**62.3**	**58.6**	**51.3***
- Local banks	--	--	42.6**	35.1	26.3
- Foreign banks based locally	--	--	4.4**	3.8	4.9
- Cross-border	9.8	6.4	15.3	19.7	20.1*
East Asia	**--**	**--**	**776.1**	**625.5**	**725.8***
- Local banks	**--**	**--**	**459.5**	**370.6**	**479.4***
- Foreign banks based locally	**--**	**--**	**69.5**	**52.1**	**52.7***
- Cross-border	**85.2**	**118.3**	**247.1**	**202.8**	**193.7***

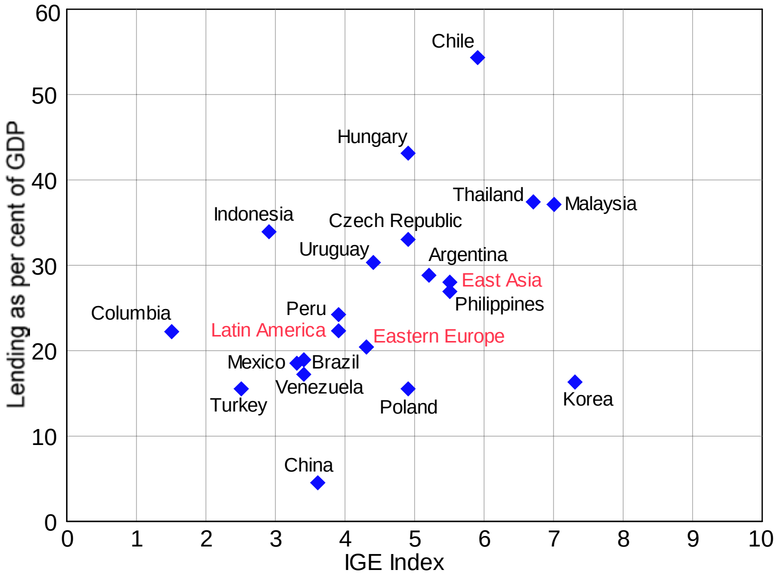
* June 2002; ** January 1997
Sources: BIS; CEIC

Over the past few years, total loan assets have once again increased steadily; with strong lending by local banks more than offsetting continued falls in cross-border lending and by locally based foreign banks. Lending to the household sector has driven the growth in loan assets. In contrast, growth in corporate sector loans over the past 5 years has been lacklustre, possibly reflecting greater caution by banks and companies as well as the continued development of local corporate bond markets, though the banking sector has remained the dominant source of finance. The strongest recovery in total bank loan assets was in Korea, such that by year 2000 total loan assets had exceeded the pre-crisis peak level.

The rapid rate of increase in bank lending, its high level relative to output and the small share, despite high growth of cross-border lending, in aggregate lending in East Asia reflect a number of factors. First, in the early half of the 1990s there was a widely shared degree of confidence about the future growth prospects in East Asia. This was in part based on the extended period of strong growth among many of the economies. Moreover, because of under-developed corporate bond markets, linked in part to small issuer and investor bases and limited liquidity in the secondary markets, and the high levels of family ownership, which typically limit companies' ability to raise equity finance, external funding for businesses in East Asia has tended to rely predominantly on bank credit.[7] The expansion of bank lending was also associated with a substantial build up of global liquidity and a general thrust towards more open and liberalised capital markets. There is prima facie evidence suggesting a positive relationship between the magnitude of cross-border lending relative to GDP in a country and a measure of that country's robustness of the institutional and governance arrangements in the banking sector (Graph 8).[8] While the graph does not imply a causal relationship, it is in line with empirical work that stresses the importance of sound governance structures as a necessary condition for a stable financial system.[9]

Graph 8

Cross-border Lending[1] and the Governance Environment[2]



Sources: ADB; BIS; IMF. 1. Average of 1998-2000. 2. 1998

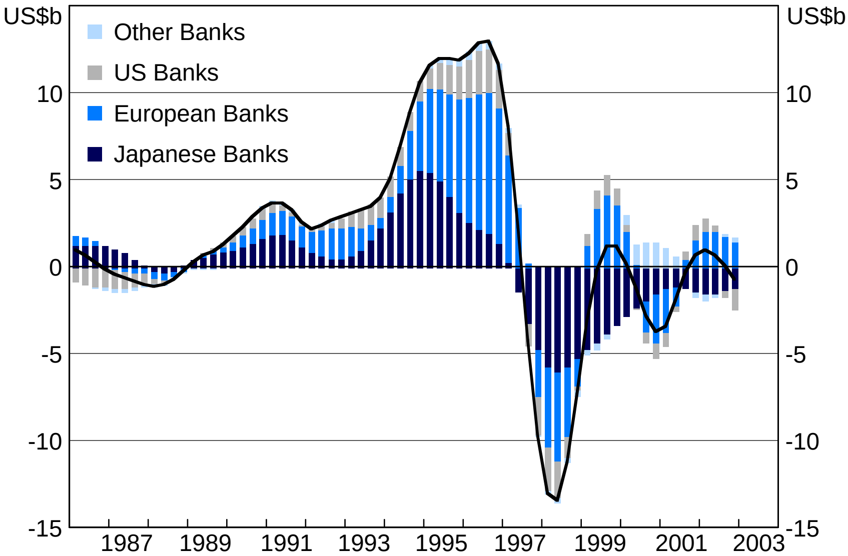
The Asian financial market crisis corresponded with, and possibly induced a number of changes in the characteristics of cross-border lending. For instance, the maturity profile of cross-border lending lengthened, although this was mostly attributable to a significant outflow of short-term debt, rather than a substitution from short- to long-term liabilities. Despite the significant outflow over recent years, short-term liabilities continue to constitute almost two-thirds of total consolidated international banks' claims on the region. Another significant change is a diversification of foreign country ownership of bank assets, as the scale of participation by Japanese banks declined. Prior to the mid-1990s, Japan was the major lender to East Asia, supplying 60 per cent of total cross-border lending (Graph 9). Much of this

7. See Shirai (2001) for an analysis of East Asia's financial structure.
8. The governance measure is drawn from a recent study by the Asian Development Bank Institute by Chan-Lee J.H and S. Ahn (2001). The index synthesising the institutional and governance environment, is normalised to a range between 0, signifying low quality institutional arrangements and 10, representing a high standard of institutional arrangements for emerging market economies.
9. See, for example, Claessens and Jansen (2000).

lending was channelled to Japanese enterprises, which were investing heavily in the region. However, as early as 1995, the flow of Japanese bank lending to the East Asian economies slowed, and since mid-1997 Japanese banks have been repatriating loans. The reduction was partly motivated by a reassessment of available opportunities in the region, and partly to meet capital requirements, with Japanese banks opting to do so by reducing their exposure to their more risky loan assets. Japan remains the major lending country to East Asia, but the proportion of cross-border lending by European and US banks has risen, to also place these countries' banks as major lenders to the region.

Graph 9

Cross-border Bank Lending to East Asia



Source: BIS

Despite greater FDI inflows and cross-border M&A transactions in the finance sector in Thailand and Korea since the crisis, there is as yet no indication of an increased share of lending by locally based foreign-owned banks relative to their domestic competitors. In fact, the market share of locally based foreign owned banks in these countries has declined, most notably in Korea. The lack of market share gains may be due to foreign banks only taking minority stakes, or forming joint ventures in domestic banks, with these banks still being classified as local banks in the credit statistics. There also appears to be no relationship between FDI in Indonesia's financial sector and growth in locally based foreign banks. In contrast, FDI in the financial sector generally shows a stronger correlation with cross-border lending, as binding capital controls discourages the entry of foreign financial institutions. However, it is not necessarily the case that financial opening/liberalisation would generate higher cross-border capital flows. The East Asian and other emerging market economies liberalised their capital account, facilitating cross-border lending, while maintaining restrictions on the presence of foreign banks operating locally, thereby limiting the scale of FDI in the finance sector.[10]

4. Forces Underpinning FDI in the Financial Sector of Emerging Markets

The main force driving the increase in foreign ownership and foreign bank activity in emerging market banking systems is regulatory reform. In the European emerging market economies this has taken place through privatisation policies, designed to help resolve the difficulties in the banking sector in some Eastern European countries. Many of the privatisations have involved foreign players from the European Union, in line with their strategic interests related to EU enlargement. Within the economies of East Asia, privatisations have been less evident, since public ownership of the banking sector has been comparatively low. Rather, the main regulatory reforms underpinning greater foreign participation have been policies designed to strengthen competition in the service sectors, including banking. The expansion of the trade liberalisation agenda to include trade in services in the mid 1990s, and technological changes that sharply reduced communication costs gave additional impetus for structural reforms.

Some of the earlier policy initiatives were designed to achieve a more open capital account, and to a lesser extent more transparent FDI policies, particularly in Korea. Initiatives to lower the barriers to financial FDI gained momentum following the Asia crisis. For instance, in 1998, Korea abolished the ceiling on foreign stock investment, giving foreign investors the right to purchase all the shares of a domestic firm.[11] The government also announced a policy of ending direct interference in bank management. Similarly, Indonesia has eased restrictions on foreign participation in existing banks and removed obstacles that prevented the opening of foreign branches. And in Thailand and the Philippines the limits on the foreign shareholding on banks were lifted, albeit for a limited duration of time, after which foreign held equity must fall to 49 per cent. Malaysia is the main exception to this trend, having opted to maintain restrictions on foreign participation in the banking sector. Even though the banking sectors of most East Asian countries have become more open and receptive to FDI, obstacles to foreign direct investment remain prevalent (see Appendix A for a summary).

Barriers to FDI distort international patterns and modes of trade and may also distort the allocation of capital between different economies, between foreign and domestic investment, between different sectors and between portfolio and direct investment. The effects of these distortions are manifest through a variety of channels, including higher prices,

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10. In principle it is possible to limit capital movement using, for instance, exchange controls while maintaining a liberal regime concerning trade in financial services. In practice though, capital controls are likely to curtail the flexibility of consumers to purchase services from foreign financial institutions. Capital controls are also likely to raise the cost of doing business and could discourage foreign bank entry.

11. While the establishment of foreign bank subsidiaries was not legally forbidden before then, in practice no licenses were given.

less consumer choice, lower capital stock and lower productivity. But quantifying these effects is difficult, as they depend on the nature of the barriers and also on the way in which they are implemented. In general, clearly specified and transparent rules will have less adverse effect on resource allocation than those measures which involve administrative discretion, and hence a degree of uncertainty for the investor. For example, a legislated 15 per cent limit on foreign ownership of companies in the banking sector is likely to be less costly than a policy which aims to achieve the same broad limits, but via a system of administrative approvals and conditions on the investment.

Moreover, there are many types of barrier, each restricting FDI to a differing degree. In order to provide a numerical measure of the barriers that takes into account the nature of each obstacle, analysts have compiled indices of FDI restrictiveness, by sector and economy-wide, which offer a yardstick for comparing FDI barriers across countries (see Box B for a discussion of the methods used, the information required and their limitations). There are a number of summary measures of inward FDI restrictiveness available, though each adopts a similar methodology and is usually based on the same information sources. While the level of indices varies and the weights used to compile them differ, they are all qualitatively similar in terms of their ranking of countries, and highly correlated with each other.

A dataset based on work by McGuire and Schuele (2000) and Hardin and Holmes (1997) for the Australian Productivity Commission offers one of the most comprehensive attempts to compile indices of restrictiveness in services sectors in both industrialised and emerging market economies. Using this dataset, Graph 10 compares for five service sectors, including banking, the level of restrictiveness in each of the East Asian economies, as well as other emerging market and industrial economies, relative to the average degree of restrictiveness in 24 countries. The graph highlights a number of features. First, among all emerging market economies, except Mexico and Argentina, barriers to FDI are generally higher in the banking sector than the other service sectors covered. Second, all the East Asian economies rank within the top 8 most restrictive banking sectors with respect to FDI; Malaysia, Indonesia and the Philippines rank respectively, 1st, 3rd and 4th. Third, in all sectors, other than maritime in Malaysia and the Philippines, East Asian countries are more restrictive than the average level of restrictiveness among the 24 countries included in the sample. This pattern of high restrictions on FDI among the service sectors in East Asia partly reflects the development strategy pursued in most of these economies, based on export led industrialisation. Accordingly, barriers to FDI in manufacturing sectors were low, even encouraged, whereas the service sectors of the economy were sheltered. This approach tended to result in a foreign banking presence that provided banking services to foreign affiliates of multinationals, but did not compete directly with established domestic banks.

Box B: Measuring Barriers to Financial Sector FDI

An evaluation of the costs and benefits of FDI restrictions requires a measure of the stringency of the policies that limit inward FDI flows. The ideal measure of the extent and size of FDI barriers by sector and economy-wide would compute their net impact on prices, enabling the calculation of a tariff equivalent. However, unlike barriers to international goods trade, which usually take the form of tariffs, restrictions on FDI are numerous in kind, are often applied by a multitude of government agencies and are less transparent in terms of their impact on prices. UNCTAD has identified nearly 60 different categories of FDI restrictions, used to varying degrees and applied with varying rigour among economies. Limits on foreign ownership in the banking sector, for instance, may differ among firms in the industry, vary according to the legal structure of investment – subsidiary or branch – are usually coupled with other restrictions, such as number of permitted ATMs (e.g. Malaysia) and sometimes applied with sunset clauses limiting the duration of a given level of foreign ownership (e.g. Thailand and the Philippines). This makes it conceptually difficult to compute and interpret tariff equivalents. Furthermore, the extensive information required is not in practice available. (See Hardin and Holmes, 2002 for a discussion of the conceptual and data limitations involved.)

In the absence of reliable tariff equivalents on inward FDI restrictions, alternative measures are used. A crude measure is a frequency ratio, which simply counts the number of barriers in each sector and how they relate to that sector's output. Such simple measures give equal weight to each barrier, even though in practice their degree of restrictiveness may vary. Moreover, multiple FDI barriers may have the same impact as a single barrier, yet would imply a more restrictive FDI environment.

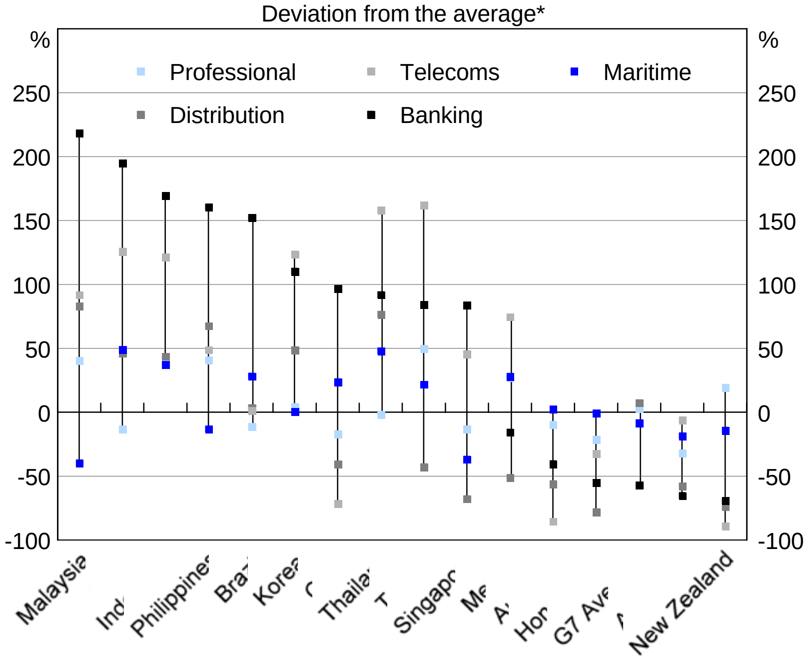
To overcome some of these limitations, a number of authors have developed restrictiveness indices on inward FDI. See, for example, OECD (2003), Hardin and Holmes (2002), McGuire and Schuele (2000) and Barth, Caprio and Levine (2001). The indices attempt to better measure the size and economic significance of FDI barriers by assigning different scores and weights to specific kinds of FDI barriers, usually distinguishing those that limit establishment of a foreign enterprise from those limiting ongoing operations of a foreign business. In assigning the scores and weights, their structure is chosen so as to ensure the more stringent the restrictions the higher the index, but without the property that more types of restrictions automatically result in a higher index value. For example, an economy that restricts the number of banking licenses to foreigners is assigned a higher score than an economy that issues new banking licenses, but imposes constraints on the hiring of foreign staff, because the latter is considered to be less restrictive.

The information source is usually each country's schedule of commitments to open services markets as reported to the General Agreement on Trade in Services (GATS), which cover virtually all of the world trade in financial services. For FDI policies in APEC countries, a more comprehensive data source is the *Guide to Investment Regimes of Member Economies*. For OECD countries, another information source is provided by the list of FDI reservations filed by OECD countries in the context of the OECD Code of Liberalisation of Capital Movements. The scores and weights chosen and the impediments to include in the index are necessarily arbitrary. In practice they only cover explicit statutory restrictions, abstracting from indirect policies that raise the cost of doing business and thus may serve to hinder inward FDI flows. Similarly the weights used to aggregate across sectors and the aggregation methodology to get an overall country index of FDI restrictiveness is arbitrary. Often, the index is scaled to lie between 0 and 1, and sensitivity analysis on the weights used for the various restrictions is provided to give a sense of the possible range of index values.

Graph 10

Services FDI Restrictiveness Indices

Deviation from the average*

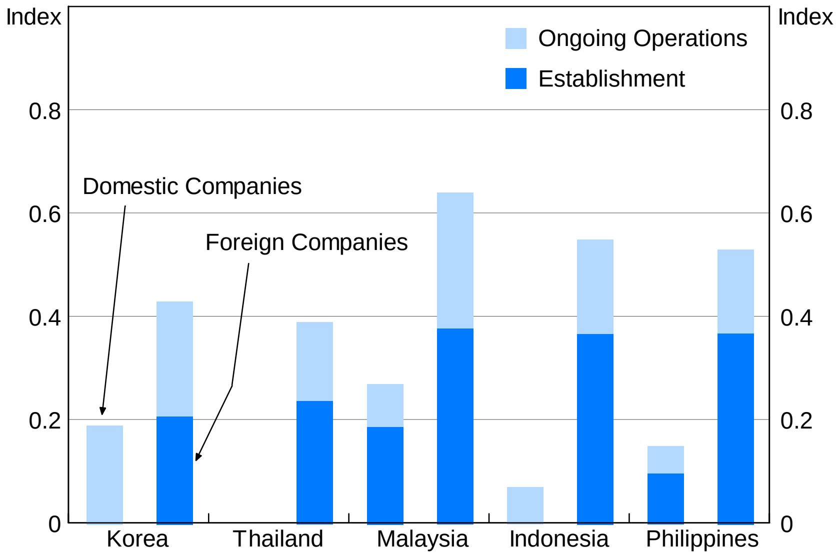


* The simple average of the index level in 24 countries, including the G7, Australia, East Asian and other emerging market economies in Asia and Latin America.

Sources: McGuire and Schuele (2000); RBA

Looking more closely at obstacles to entry in the banking sector of the East Asian economies, McGuire and Schuele decompose entry barriers faced by domestic businesses and those faced by foreign companies. They also disaggregate barriers according to what aspect of the investment they most affect, either in terms of barriers to establishment or barriers to ongoing operations, such as licensing requirements for managers and limits on the number and length of stay of foreign personnel (Graph 11). Such a disaggregation offers a better indicator of the degree of discrimination against foreigners, as the discriminatory nature of the obstacles depends on the extent to which the same or different barriers are applied to domestically owned establishments. Nonetheless, based on the difference between the index number for foreign and domestic establishments, all the East Asian economies still discriminate against foreign banking businesses, but Malaysia appears relatively less so, since domestic barriers to entry and on ongoing operations are also high.

Graph 11
Index of Restrictiveness in the Banking Sectors of East Asian Countries

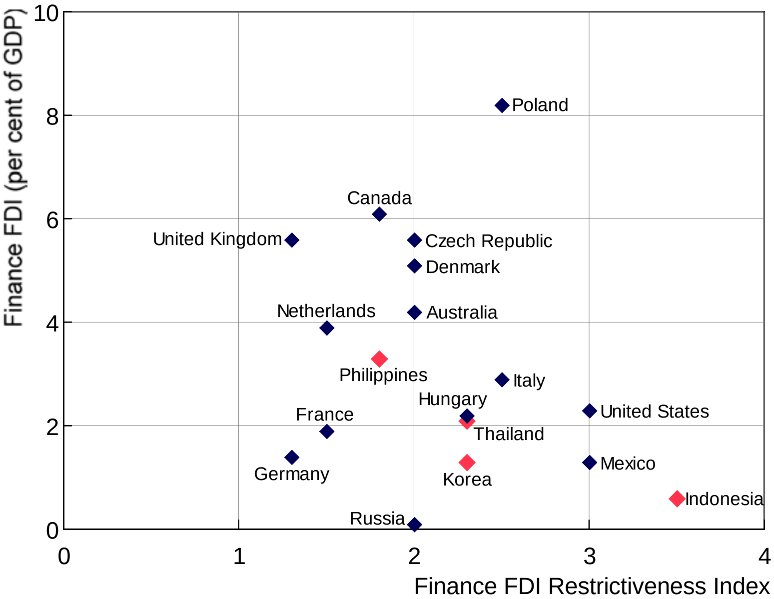


Source: McGuire and Schuele

Of course the decision to locate investment in another country depends on a wide range of factors, other than the regulatory environment. Economic factors, transparent and operational legal frameworks, low corruption, familiar business customs, proximity and historical ties are some of the other standard determinants. From an overall perspective, the East Asian economies are considered favourably among multinationals as hosts of new FDI. An UNCTAD survey conducted in 2001, showed that after China, Indonesia, Thailand and Malaysia were the most favoured host economies as a location for FDI, and Korea was ranked 6th among the developing Asian economies. Nonetheless, the especially large obstacles to FDI in the finance sector may well have skewed the composition of FDI in favour of those sectors more welcoming of FDI, notably manufacturing. Graph 12 offers some prima facie evidence of this, suggesting a negative relationship between the stock of FDI relative to GDP and the World Bank measure of FDI restrictiveness in the finance sector.[12]

12. The World Bank measure is shown, because it covers a larger number of countries where data on the stock of finance FDI are also available. The World Bank index ranges between 0 and 4, with a higher number indicating a greater degree of restrictiveness.

Graph 12
Stock of Finance FDI and Foreign Bank Restrictions



Sources: World Bank, OECD, UNCTAD

5. Impacts of Financial Sector FDI and Policy Issues

The relationship between FDI and economic performance is a complex one. The channels are numerous, with linkages between FDI and higher investment and trade, the transfer of technology, innovation, stronger competition and diversification of risk. All of these linkages are forces that contribute positively to output growth, though they do not accrue automatically, and in most cases are conditional upon the existence of relatively developed domestic institutions and sound macroeconomic policies. Few would disagree that this view is generally supported by the vast empirical literature on FDI.[13] Nevertheless, following the financial market crises in many emerging market economies in the second half of the 1990s, the role of FDI in development has come under closer scrutiny. The issues include, whether financial FDI is somehow different from FDI in other sectors, the relationship between financial sector FDI and risk management practices and whether these contributed to contagion, and whether more liberal banking FDI policies and few capital controls led to higher fragility of the financial sector and, to the extent that financial sector FDI entails downside risks, how best to design policies and institutions to minimise the costs while ensuring the benefits of FDI. It is not, however, the purpose of this paper to address these issues. Rather this section aims to briefly review some of the linkages between FDI and economic performance and indicate their possible policy implications. Specifically, we examine the relationship between foreign bank involvement, competition and efficiency in the banking sector, and secondly between financial sector FDI and the quality of corporate and

13. See, for instance, OECD (2002) for a survey of the empirical literature on the relationship between FDI and

public governance in the banking sector.

FDI and the presence of foreign banks exert a significant influence on domestic competition in host-country markets. This can create pressures for financial institutions to reduce costs, improve the quality of services, and broaden the product range and spur financial innovation. However, the entry of foreign banks may also raise the level of concentration in host-country markets, which can weaken competition. A high level of concentration leaves the banking sector potentially more exposed to large economic costs in the event of a bank failure. On the other hand, larger banks may act as a source of stability, and in this regard foreign owned banks with a large stake in emerging markets potentially play a stabilising role, as these banks are better positioned to geographically diversify their exposure to risk. Concerns that greater international competition would lead to increased concentration in the banking sector do not appear to have materialised. Between the beginning and the end of the 1990s, concentration of the banking system in East Asia, as measured by the share of assets held by the five largest deposit-taking institutions has remained broadly steady, and at about the same level as the average among advanced industrialised economies.

More generally, it is difficult to quantify the influence of FDI on efficiency, as it is not clear how competition should be measured, or how to separate the contribution of FDI from other forces bearing on the efficiency of financial markets. In practice, therefore, the focus is usually on financial performance measures, such as operating costs, pre-tax profits and non-performing loans as a share of total assets. Such measures of banking sector performance in East Asia have improved in recent years, with substantial inroads made towards resolving non-performing loans, particularly in Korea and Thailand, and improved bank profitability across the region. However, it is not possible to attribute these improvements in bank performance to more intense foreign competition. Indeed, in most East Asian economies domestic banks appeared to perform better in 2002 than foreign based banks, except in terms of the level of non-performing loans relative to assets (Table 7).

Financial sector FDI in East Asia has created a demand for improved governance structures, as well as being a source of better governance arrangements. Foreign banking businesses boost demand for better regulatory structures overseeing, for instance, bank supervision, as such arrangements bear on corporate risk management practices and are an important factor influencing where, how much and in what form to invest in a host country. For this reason, countries that have sought to facilitate higher FDI inflows have implemented reforms that inter alia aim to improve governance arrangements. Foreign bank entry is also likely to have a feedback effect on regulatory arrangements, as foreign entrants tend to be more innovative and sophisticated in their use of risk management products than domestic incumbents. This is one of the channels driving enhanced financial system efficiency, but regulatory systems need to adapt to ensure such products do not deliberately, or

output growth.

inadvertently usurp prudential regulations or expose the financial system to excessive risk. Typically though, closer capital market integration, in particular through FDI has been shown to promote financial development, raise prudential supervision standards and compliance, especially insofar as source FDI country regulators oversee foreign operations, and enhanced the quality of risk management by broadening the capital base of the banking sector.[14] Moreover, financial sector FDI has facilitated the transfer of technology, such as advanced financial management systems, and the diffusion of marketing expertise. These features have motivated the acceptance of foreign takeovers in banking crisis resolution programmes (e.g. in some Eastern European economies).

Table 7: Bank Performance Indicators in East Asia (2002)

	Percentage of Total Assets		
	Domestic Banks	Foreign Banks	All Banks
Korea			
Net Interest Revenue	2.4	1.7	2.3
Other Income	1.3	0.8	1.3
Operating Costs	1.5	1.9	1.5
Loan Losses	1.1	0.4	1.1
Pre-tax Profits	1.0	0.3	1.0
Thailand			
Net Interest Revenue	1.9	2.6	2.0
Other Income	0.9	1.3	1.0
Operating Costs	1.9	2.3	1.9
Loan Losses	0.4	3.5	0.9
Pre-tax Profits	0.6	-1.9	0.2
Malaysia			
Net Interest Revenue	2.6	2.6	2.6
Other Income	1.1	0.8	1.1
Operating Costs	1.6	1.2	1.6
Loan Losses	0.8	0.7	0.8
Pre-tax Profits	1.3	1.5	1.4
Indonesia			
Net Interest Revenue	3.8	1.7	2.1
Other Income	1.0	4.1	3.5
Operating Costs	2.6	4.9	4.5
Loan Losses	1.0	0.4	0.5
Pre-tax Profits	1.6	1.6	1.6
Philippines			
Net Interest Revenue	--	--	4.0
Other Income	--	--	2.3
Operating Costs	--	--	5.4
Loan Losses	--	--	0.8
Pre-tax Profits	--	--	0.1

Source: Bankscope

14. For empirical studies see, for instance Demirguc-Kunt and Detragiache (1999) and Claessens and Jansen (2000).

6. Conclusions

This paper has provided an overview of the magnitude, structure and forces shaping financial sector FDI in the East Asian emerging market economies over the past decade or so. The experience of foreign involvement in the banking sectors of Asian economies, and how it has evolved provides an interesting case study, as the underlying forces differ in a number of significant ways from other emerging market economies. Regardless of the measure used, the presence of foreign banks in East Asia is low compared with the emerging market economies of Latin America and Eastern Europe. However, as in other regions, there has been a marked trend towards closer integration of markets, underpinned by technological innovation, lower transaction costs, the opportunity for risk diversification and in line with strategic considerations. In East Asia, however, an added impetus in most countries has been the implementation of financial market reforms designed to strengthen institutional and governance arrangements and competition in the banking sector, in part through foreign bank entry. This has led in a number of countries to lower barriers to FDI in the financial sector. While some initiatives towards achieving more open banking sectors were implemented in the first half of the 1990s, notably in Korea, it was the financial market crisis in 1997 and 1998 that provided a fillip to regulatory reforms. The level of financial FDI and cross-border M&A activity rose sharply in all the East Asian economies, except Malaysia, where barriers remained prevalent and in Indonesia, reflecting the volatile economic and political situation. As a result, all measures of the level of foreign involvement in the banking sector have risen over the past 5 years, though they still remain lower than in other emerging market economies. Despite the implementation of many market-opening initiatives, obstacles to financial FDI (and in other service sectors) remain prevalent in East Asian economies. This partly reflects a legacy of the development strategy pursued in most of the East Asian economies, based on manufactured export led industrialisation. Accordingly, while barriers to FDI in manufacturing sectors were low, even encouraged, the service sectors of the economy were sheltered. This tended to result in a foreign banking presence that provided banking services to foreign affiliates of multinationals, but did not compete directly with established domestic banks, and also appears to have had an effect on the composition and perhaps the level of FDI. While still too early to tell, concerns that greater international competitiveness would lead to increased concentration in the banking system and less domestic competition do not so far appear to have materialised. Rather, closer capital market integration, in particular through FDI, has facilitated the transfer of technology, such as management information systems, promoted financial development and created further pressure for improved governance structures, though these benefits are difficult to quantify.

Appendix A: Obstacles to Financial Sector FDI in the East Asian Countries

The main source of information on obstacles to finance FDI is the GATS schedules, given the close relationship between FDI and services trade. The GATS schedules are classified according to the following four modes of service delivery:

- Cross Border Supply, where the supplier and consumer are located in different countries. For example, financial services connected with the provision of a cross border loan. (If a loan involves international capital and is provided by a domestic bank, there is an international capital flow, but no services trade or FDI.)
- Consumption Abroad, where a consumer consumes the services of the foreign supplier in the supplying country, such as the purchase of financial services by consumers while travelling abroad.
- Temporary Movement of People Services, where a supplier moves temporarily to the consumer. Examples include the provision of financial consulting services and the intra-corporate transfer of bank managers.
- Commercial Presence, where the supplier establishes a physical presence so as to supply services in a foreign country. An example is the acquisition or establishment of a bank in another country.

The GATS country schedules lay down how countries plan to implement the market access and national treatment obligations in each of these four modes of delivery. Market access involves a commitment not to maintain or adopt measures which limit the number of service suppliers or the value of their service transactions, impose economic needs tests, restrict the type of legal entity through which a supplier may supply a service, or limit the share of foreign ownership in the value of individual or aggregate investment. The national treatment obligation requires that countries apply no less favourable treatment to foreign suppliers than they apply to domestic suppliers. Existing measures that violate the principles of the GATS can be exempted. In this case, a country provides a list of specific exemptions to the schedule, which are labelled ‘unbound’. Commitments and exceptions can be applied to all sectors or only to specific sectors.

While the first 3 modes of service supply do not typically require FDI, or if so, only limited FDI, the fourth mode of supply, commercial presence, is closely linked to FDI. Obstacles to financial sector FDI are thus usually based on the GATS schedules for the fourth mode of service delivery in the banking sector. Mattoo (2003) has compiled a table that characterises the nature of the limitations on commercial presence in the banking sectors of the East Asian economies. Table A1, on the following page, is based on this work, with additional information from Kim (2002) and Hardin and Holmes (1997).

Table A1. Limitations on Foreign Bank Commercial Presence in East Asian Economies

	Screening	Ownership restrictions	Management and operational restrictions
Indonesia	Yes	None listed for new licenses. For existing Banks, foreign owned equity is limited to 49 per cent. Local incorporation is required .	Higher paid up capital is required for foreign service suppliers than for domestic service suppliers. Branch offices allowed only in 10 cities. Managers or technical experts granted 3 year extendable visas, but require 2 equivalent Indonesian staff for each foreigner.
Korea	Yes	In 1998 most restrictions were removed to increase commercial presence. Currently, only representative offices or branches of foreign banks are permitted. Branches may only be opened one year after the establishment of a representative office.	Restrictions on foreign currency loans and deposits and foreign exchange services. No restrictions on expatriate staff. Korean banks can recruit foreign nationals as directors since May 1998.
Malaysia	Yes	Foreign shareholdings in existing local commercial banks are not to exceed 30 per cent. The 13 wholly foreign owned banks are permitted to remain. No new licenses are allowed.	An institution owned or controlled by a foreign government is not allowed to control a commercial or merchant bank Expatriate staff are not granted visas except for temporary presence of senior staff and specialists.
Thailand	Yes	No restrictions for existing foreign bank branches. Foreign shareholdings in commercial banks are not to exceed 49 per cent. Limitations on individual ownership.	Managerial, executive and specialist staff granted visa for a 1 year period, which is extendable for no more than 3 years. Existing banks with a branch before 1995 limited to 2 new branches.
Philippines	Yes	Local incorporation required. Foreign shareholding Or acquisition in a new investment limited to 51. per cent. The foreign share of total assets is limited to a maximum of 30 per cent.	10 new branches allowed between 1995 and 2000, with a limit of 6 from a single bank.

Sources: Based on Mattoo (2003), Kim (2002) and Hardin and Holmes (1997).

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