Regional Integration and Financial Foreign Direct Investment[1].

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Introduction

Throughout the 1990s many developing countries abandoned previous inward looking economic strategies, opened their markets to FDI and lowered tariff and non-tariff barriers to trade. At the same time many of these countries entered new Regional Integration Agreements (RIAs) either with developed countries or with other South countries. This revival of regionalism has been explored in a myriad of theoretical and empirical papers by trade economists who analyze both the rationale of regionalism and the possible welfare implications of preferential liberalization.

In a parallel move, the 1990s witnessed an impressive increase in FDI that was largely driven by increases in FDI in services, and in particular in financial FDI (FFDI). As the growth of FFDI gained in pace, finance economists have been producing an equally impressive amount of work on the micro foundations of the internationalization of the banking sector and, at the macro level, on the welfare impact on host countries of foreign bank entry.

These two branches of thought, however, have never met. The different studies that approach the question of location of foreign banks[2] have explored macro and micro determinants of banking location without any explicit reference to regional agreements. Similarly the studies of regionalism have explored the rationale for and the implications of preferential liberalization on goods trade and real FDI, without considering its implications on trade in services. And yet many of the new regional agreements cover the liberalization of services and the free movement of capital, and many more have been explicitly promoted as valid vehicles to increase foreign direct investment.

The efforts of emerging markets to attract financial foreign direct investment are based on a general agreement on the befits that may be derived from this particular form of capital flows. FFDI can be expected to bring about better management techniques and advanced technologies, to facilitate emerging markets' access to the international capital markets and, above all, to sustain more stable capital flows as compared to the highly volatile portfolio investments. Although analysts have also questioned the unqualified acceptance of FFDI as panacea, a broad consensus remains that given certain important conditions

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1 The views expressed in this paper are those of the author and do not necessarily reflect the position of the Swiss National Bank I am grateful to Ricardo Guth for his assistance work in the building of the data base. Also to Marcel Peter and Andreas Fischer for comments on previous drafts. The usual disclaimers apply.

2 See for example Claessens et. al. (1998) Focarelli,D. And F. Pozzolo (2000) for cross section studies on Foreign Bank location

such as an adequate regulatory environment, developing countries should benefit from the gradual liberalization of FFDI.

As in the realm of trade in goods, FFDI liberalization may, and has been pursued unilaterally or on a preferential basis. The purpose of this paper is to approach this issue from a theoretical point of view and to assess empirically the relative success of the paths of liberalization followed by different emerging markets in the last decade.

The welfare implications of preferential liberalization are largely determined by sector-specific considerations. Drawing on Matto and Fink (2002), I argue that the need of regulatory cooperation in the financial sector may make regional integration a 'natural' step towards further financial liberalization. Moreover, in the case of the financial sector, as opposed as in the case of trade in goods, preferential liberalization necessarily enhances welfare because entry barriers in this realm normally do not create government revenue. Yet, even in this case regionalism may come at a cost. If location-specific sunk costs are high, as seems to be the case in the financial sector, preferential liberalization may durably deter competition from more efficient suppliers, and the benefits of liberalization could be limited.

The empirical assessment of unilateral and preferential measures of liberalization shows that for some developing countries, and in particular for the ASEAN countries, preferential liberalization is having a strong impact on intra regional FFDI at the expense of FFDI from the rest of the world. If the ASEAN countries will benefit from the increase in competition from other regional banks the expected spillovers of foreign bank penetration may be moderate. Further, the regional concentration of foreign ownership may jeopardize the stabilizing effect of foreign bank presence.

In contrast, in the case of Mercosur, preferential and unilateral liberalization have evolved in a parallel way resulting in large increases of foreign bank penetration from within the area and from the rest of the world. In the present static analysis, this second path of liberalization seems preferable because it minimizes the possible distortions brought about by regionalism. A final verdict on the superiority of these two modes of liberalization, however, goes well beyond the scope of this paper since it would require an analysis of the sequence of liberalization implied by each of them.

The rest of the paper is presented as follows. The first part explores the conceptual framework for the analysis. The second part briefly describes the state of multilateral liberalization and the RIAs included in the paper. The third part presents the empirical results and the fourth part concludes.

The conceptual framework

1. The conventional analysis of Regional integration and real FDI and its pertinence to FFDI

The conventional analysis of regionalism identifies two main effects of preferential liberalization: its impact on trade flows, and its impact on the location of production. Regarding trade flows, the effect of preferential liberalization is a shift of demand form domestic production and supply from the rest of the world towards supply from member

countries. The coined terms for these two effects are trade creation, the shift of demand towards more efficient suppliers, and trade diversion, the shift of demand towards less efficient producers. Whereas trade creation is always beneficial, trade diversion may reduce welfare. In particular, governments may lose tariff revenue and the overall effect on national welfare will depend on the net effect of this loss and the costs of alternative sources of supply.

Further, the shift in trade flows affects production location. Within the integrated area, firms may choose to leave some countries and set shop in others according to the countries' comparative advantages, location and agglomeration effects. The new economic landscape also affects FDI flows from the rest of the world. Firms may be attracted by the enlarged market that results from integration; FDI from the rest of the world may also increase as a result of strategic responses by firms located outside of the integrated market whose exports would be 'punished' by the preferential treatment given to members; or FDI may increase due to some complementary between the increase in trade flows and new FDI.

What about FFDI? Most of the existing literature on the welfare impact of preferential liberalization is centered on trade in goods. An important exception is Matto and Fink (2002) who examine the possible implications of preferential liberalization on trade in services. The central conclusion of their paper is that, in contrast to the case of trade in goods, where preferential agreements may reduce welfare, in the realm of services regionalisms is necessarily welfare enhancing, as long as all barriers to entry are removed[3]. This specificity of trade in services stems from the fact that barriers to flows of services 'are often prohibitive and non revenue generating, so there are few costs of trade diversion'.

Yet unilateral liberalization dominates even if in the realm of services. The downside of preferential liberalization in trade in services stems from the 'location-specific sunk costs of production (which) are important in many services, so (that) even privileged access for an inferior supplier can translate into a long-term advantage in the market'. Preferential market access provides firms with a first- mover advantage to a degree that may durably deter future competition by more efficient outside firms. 'How much this matters depends on whether the provider who benefits from preferences is the most efficient provider globally'.

Despite of the generally accepted superiority of unilateral liberalization over regional integration, countries have been following both routes of liberalization in parallel ways. The case for regional integration has been made on many grounds. Preferential liberalization may allow countries to gain at the expense of the rest of the world through changes in their terms of trade; countries may pursue the regional route because negotiations may be easier by reciprocal-based bargaining; regionalism may be also be

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[3] Liberalization, whether preferential or unilateral, may reduce welfare only when there are restrictions in the number of firms allowed to enter. The main reason is that even though consumers may benefit from the increase of competition, this gain may be offset by the transfer of rents from local oligopolists to foreign oligopolists.

preferred if regulatory cooperation is easier to achieve among a small subset of countries; and finally, countries may endorse regionalism to lock-in economic policy reforms. Of these reasons I shall concentrate on the need for regulatory cooperation which is perhaps the most salient feature of trade in services.

'The economic case for regulation in services, as in the case of goods, arises essentially from market failure attributable to three kinds of problems, asymmetric information, externalities, and natural monopoly or oligopoly. In the first two cases, national remedial measures can themselves become an impediment to trade; in the third case, it is the absence of national regulation that can create trade problems. In order to ensure that domestic regulations at home and abroad support trade, a country must decide on the appropriate forum (multilateral, regional) and the approach (international rules, mutual recognition or harmonization) to pursue in each service sector' (Matto, Fink 2002).

Internationals rules facilitate unilateral liberalization but can do little to address impediments to trade that arise from fundamental differences across countries in standards. For instance, countries may be wary to open their borders to suppliers from countries with different quality standards in banking supervision. As noted by Sorsa (1997) 'The somewhat cautious liberalization by industrial countries in the GATS compared to their more liberal commitments in other fora such as the EU, NAFTA or the OECD, probably reflects a reluctance to open up markets to financial institutions from countries with diverse prudential supervisory systems. This may be due to a desire to limit potential systemic risks from the introductions of unsound foreign financial institutions into one's own market'.

Mutual recognition or harmonization is also easier to achieve when foreign regulatory preferences are similar and regulatory institutions are compatible. This, in turn, may depend on historical ties between countries, geographic proximity, language, legal systems, etc. In this sense, regionalism may be seen as a 'natural' step in the internationalization of financial services. Countries within a RIA would benefit from the increase in competition in their banking sectors and, if the RIA's standards are better than the national regulation, they will also benefit from regulatory improvement.

2. The liberalization of FFDI at the multilateral and regional levels

Many thorough studies analyze in depth the institutional arrangements of the multilateral framework of liberalization of trade and services and of the different regional agreements in place[4]. I shall limit myself here to a very brief description of the most salient results of the GATS negotiations and of the main aspects pertinent to FFDI in each of the five agreements (ASEAN, The Andean Community, The EU, Mercosur, and NAFTA) covered in this paper.

The Multilateral liberalization of the Financial Services

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[4] See for example Empel and Mörner (2000), Gardener(2000) and Frankel,J.A. (1996)

About two thirds of WTO members that participated in the Uruguay round trade negotiations made some specific commitments in financial services. Under GATS service sectors were bound in four different modes of supply: Mode 1 : Cross - border supply, whereby consumers or financial institutions in one country are allowed to take a loan abroad or purchase securities from foreign banks located abroad supplying the service across the border; Mode 2: Consumption abroad, in which a country allows its consumers to purchase services abroad from a foreign supplier; Mode 3: Commercial presence, whereby a country allows, for example, the establishment of foreign banks in its territory; and Mode 4 which covers the supply of services through the presence of natural persons of a country in the territory of another country.

On the basis of the individual countries commitments Qian (2000) calculated an index of financial liberalization for the different modes of market access negotiated under GATS. As the index shows (see graphs 1 and 2) in practice bindings were more restrictive for mode 1, probably because countries are reluctant to allow foreign service providers to enter their markets to provide services without being able to monitor them. In contrasts, most countries, and especially developing countries, have liberalized mode 3 (commercial presence). Indeed, countries like Chile, Argentina, South Africa or Mexico, have made far more liberal commitments than the EU or the USA. National policies, thus, seem to be have been geared towards attracting foreign banks and particularly so among emerging markets.

Regional Agreements.

ASEAN is the loosest of the agreements included here. It acts more as a forum for economic and political cooperation than as an economic integrated area. ASEAN aims at the creation of a Free Trade Area but this goal has been difficult to achieve The ASEAN countries expect to achieve an FTA by the year 2015. Four of its ten member states are included in this study: Malaysia, Singapore, Philippines and Thailand.

In contrast to other developing countries, the ASEAN members have strong domestic banking sectors and traditionally have been wary of financial liberalization. In the wake of the Asian crisis, however, amid increasing pressure on the region's financial systems some steps were taken to allow for limited entry to re-capitalize the system. Internally, in 1997, ASEAN issued the Ministerial Understanding on ASEAN Cooperation in Finance, to 'further enhance cooperation in the field of capital markets, encourage and facilitate the free movement of capital and other financial resources '.

ASEAN does not have a common external policy with regard to FFDI and national policies differ greatly between its members. Heavily hit by the crisis Indonesia, for instance, removed all restrictions on the establishment of new banks and relaxed restrictions on foreign participation in existing banks. At the other extreme, Malaysia, relatively spared by the crisis, maintained its 30% limit on foreign ownership. In the middle of the way, Thailand and the Philippines lifted foreign shareholding limits on banks, but ruled that a majority stake in domestic banks can only be held for 10 or 7 years, respectively (see Chua Hak Bin 2003 for a detailed description of financial reform in ASEAN).

Andean Community: Comprises Colombia, Bolivia, Ecuador, Peru and Venezuela. An inward looking bloc from the time of its creation in the 1960s to the early 1990s, the Andean Community went through considerable reform in the early 1990s. The traditional hostility towards foreign trade and investment was abandoned by the AC and a Common External Tariff, implying significant reductions in the pre-arrangement tariff structure for all members started to operate in 1993. FDI was given national treatment in 1991. The agreement does not provide for specific rules for integration in the financial sector. Externally, all countries, with the exception of Ecuador, made similar relatively open bindings under GATS (see graphs 1 and 2).

The European Union. The deepest integration agreement in place EU started by pursuing the regional harmonization of the different national financial regulations. This ambitious plan, however, proved unrealistic and, in 1989, with the adoption of the Second Banking Directive, the EU changed gear and espoused a more pragmatic approach based on the concepts of mutual recognition, home state control and minimum harmonization. The essence of the system is that operations of banks within the EU should be regulated by the state in which the bank has its headquarters. In principle, this should avoid financial institutions having to comply with different regulatory requirements. Nevertheless, there remain exceptions to the general requirement of mutual recognition. The Second Banking Directive states that ' Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same manner as in the home member state, as long as the latter do not conflict with legal provisions protecting the general good in the host member state' (CEC 1997)

NAFTA: To a large extent NAFTA can be seen as an expansion of the 1988 Canadian-US free trade agreement CUSFTA, which lifted many entry barriers to the provision of financial services between the two countries. NAFTA, signed by Canada, Mexico and the United States, entered into force in January 1994. Like the EU, NAFTA explicitly considers the liberalization of financial services (Chapter 14) but, unlike the European agreement, NAFTA keeps the supranationality at a minimum, relying rather on working groups to deal with different issues of economic integration. The Financial Committee supervises the functioning of the agreement and there is a dispute settlement mechanism specific to financial services. A non complying party may have its benefits in the financial sector suspended.

Since CUSFTA had already liberalized financial services between Canada and the United States, the largest impact of NAFTA was to be for Mexico. Concerns regarding the Mexican banks' ability to withstand open competition from US and Canadian banks resulted in a delayed schedule for the opening of the Mexican financial system. The country was allowed to maintain share limits during a transitional period ending in 2000, when US and Canadian banks were to be allowed in an unrestricted way.

The peso crisis of 1994 however, accelerated the financial reform in Mexico. In the aftermath of the crisis, the Mexican authorities were forced to intervene many banks that could not continue to operate as solvent entities (see Pablo Graf 1999 for a detailed description of the crisis and the ensuing reforms of the Mexican banking sector). The lack of domestic resources to re-capitalize the industry led the authorities to lift some restrictions on the foreign ownership of banks.

MERCOSUR Signed between Argentina, Brazil, Paraguay and Uruguay in 1991 the Mercosur treaty aimed at, and accomplished, the establishment of a customs Union in 1995. The institutional structure of Mercosur was defined by the Ouropreto protocol in 1994. In 1997 services were incorporated into the free trade area. Regarding regulation, Mercosur allows member countries to negotiate bilaterally mutual recognition in the financial sector.

However, the most important changes with regard to financial liberalization had taken place at the national level and most were undertook before the start of the multilateral liberalization at least in Argentina and Brazil.

The introduction of the convertibility plan in 1991 marked a turning point in the Argentina's economic history. 'It heralded profound monetary and fiscal reform, broad deregulation of domestic markets, privatization of a majority of government owned entities, trade liberalization, elimination of capital controls and, more generally, a macroeconomic environment conducive to foreign investment' (Dages, Goldberg and Kinney 2000). Later, in the wake of the Mexican crisis of 1995 which severely tested the Argentinean financial system, financial sector reform was accelerated and foreign banks were permitted to play an important role in re-capitalizing the banking system.

In the case of Brazil a major process of structural change was triggered by the introduction of the Real Plan in July 1994. (see for a detailed description of the banking reforms in Brazil Geraldo Maia 1999). Hyperinflation was curved and a process of financial sector restructuring ensued whereby the number of operating banks was largely reduced and the state owned banks were privatized. As in the Argentinean case, contagion from the Tequila crisis put significant pressure on the Brazilian financial system, forcing the government to speed up the process of bank restructuring and to call in foreign banks to help with the re-capitalization of the system. To facilitate the entry of external institutions, the restriction that the minimum capital for a foreign bank had to be twice as large as that required for a national bank was eliminated in the late 1990s.

3. *Empirical Assessment*

Methodology

The interest of this paper is the relationship between foreign bank presence and preferential liberalization. To identify this relationship I follow the empirical literature on foreign bank location (see Focarrelli and Pozzolo 2000 and Claessens et. At. 1998). This involves cross-country regressions including a number of variables that seem to perform robustly in the literature. To these variables I add an indicator of multilateral liberalization and a series of dummies that capture regionalism.

$$\log(1+FFDI_{ij}) = \alpha_1 * D_i + \beta_1 * \log GDP_j + \beta_2 * \log GDPPC_j + \beta_3 * \log Dist_{ij}$$

$$+ \beta_4 * LANG_{ij} + \beta_5 * \log OPEN_j + \beta_6 * KCONTROL_j + \beta_7 * \log(M2/GDP)_j +$$

$$\beta_8 * \log P_j + \beta_9 * \log TAXF_j + \beta_{10} * \log ROAA_j + \beta_{11} * CONCEN_j +$$

$$\beta_{12} * GATS1_j + \beta_{13} * GATS3_j + \beta_{14} * RIA + \beta_{15} * UNILATERAL$$

All quantitative variables enter the equation in log form. The Dependent variable FFDIij is foreign bank entry measured as the share of Foreign owned assets of source country i over the total bank assets in host country j or, alternatively, the ratio of the number of foreign owned banks from country i over the total number of banks in country j. Since many entries for this variable can be expected to be zero, and since these zero entries provide valuable information that would have to be dropped otherwise, the dependent variable is defined as log (1 + FFDI) . FFDI is taken from Bankscope and the values are as of end 2000.

Explanatory variables are 1995-1999 averages. Di is dummy for each of the sources. GDP and GDP per capita are, as usual, proxies of market size and economic development of the host country. Proxies of Transactional costs are distance between the source and the host countries, adjacency, and the presence of a common language between the countries. OPEN is the traditional measure of trade openness (imports plus exports over GDP). The presumption is that countries with relatively open trade regimes are more attractive to foreign investors and may also have relative open FDI regimes. KCONTROL, Capital Controls in the host country is a dummy that takes the value of one if the host country imposed controls on either outward or inward capital flows in 1997. There is evidence that the depth of the host country's financial sector attracts FFDI. The ratio of M2 to GDP is a traditional measure of financial depth. Pj refers to past inflation (average of the inflation rate in the previous 5 years) and is included here as a measure of macroeconomic stability. TAXF is the ratio of taxes to total assets paid by foreign banks in the host country. It is measured as a weighted average (weighted by assets) of taxes paid by foreign banks between 1995 and 1999. There is also evidence that foreign banks are attracted by markets with high profitability and low levels of concentration. That is, by markets exhibiting some inefficiencies but relatively low entry barriers. This characteristics of the host country domestic banking sectors are captured by the average profitability of domestic banks (ROAA/ total assets) in 1995-1999 and by the share of the largest five banks on the total assets of the banking sector. All banking variables are taken from Bankscope. To deal with outsiders, inflation, taxes, profitability enter the equation as Log[(Var/100)+1].

The two proxies for multilateral liberalization GATS1 and GATS3 are taken form Qian's index of financial liberalization in 1997, derived from the countries commitments under GATS for Mode1 (Cross border activities) and Mode3 (establishment). Qian index varies from 0 (most restrictive) to 1 (most liberal). Here they enter as (GATS index - Min GATS index)/(Max Gats Index - Min Gats Index)

The impact of regional agreements is captured by a set of dummies that take the value of 1 when both countries, host and source, belong to the same agreement. RIA, thus, captures intra-bloc FFDI. As mentioned above, usually in the wake of financial crisis, many developing countries unilaterally accelerated the opening of their financial systems. To avoid assigning to an RIA what in fact should be related to national policies additional country dummies are included. These host country dummies should, in the absence of missing variables, capture the impact of unilateral policies on FFDI. In this light, the RIA dummies measure the additional impact on the agreement on intra-bloc FFDI, while the host dummies measure the general openness of each country to FFDI from within the region and from the rest of the world.

Bilateral data gives a total of 2127 observations, of which 352 are positive entries. Given the large share of zero entries the Tobit method of estimation was used. Countries included in the sample, RIA membership the total number banks and the share of foreign banks in each country are shown in table 1. Source countries are OECD members plus all members of any of the RIAs included here. As it is apparent from this table, some countries have information for a very small number of banks. To avoid giving too much weight to these figures, where the quality of the information is also likely to be less good, the estimations were weighted by the total number of banks in the host country.

Results:

Results are presented in tables 2 and 3. With regard to the impact of GDP and GDP per capita on FFDI, I find that foreign banks are more numerous in larger countries but the size of their investment does not depend on this variable. Further, foreign banks seem to be indifferent to the level of development of the host country.

The empirical literature offers mixed results with regard to the relation between market size and the level of development of a host country, and the presence of foreign banks. Claessens et. al. (1998), for example, analyzing foreign bank entry across 80 developed and developing countries in the period 1988-95, find a positive relation between bank entry and GDP per capita. In contrast, Focarelli and Pozzolo (2000) studying foreign bank presence in the OECD countries, find a negative relation between per capita income and real GDP and interpret these results as signaling banks preference for countries with high expected rates of growth. Goldberg and Johnson (1990) find that while the number of US banks in a country is positively correlated with the host's per capita income, the relation is negative when entry is measured in terms of assets.

More important than size or development seem to be the host country trade openness, the 'cultural' distance between countries -captured by adjacency and common language- and the level of development and openness of the domestic financial sectors. Banks, indeed, seem to prefer countries with domestic banking sectors exhibiting high profitability but relatively low levels of concentration and where foreign corporates face relatively low taxes. In these countries, there are both more and larger foreign banks.

Turning now to the variables related to multi and plurilateral liberalization, countries bindings under Mode1 in GATS have a strong positive effect on foreign bank entry, suggesting important complementarities between the liberalization of cross border operations and FFDI. GATS3, the index of liberalization of commercial presence, has also a positive and significant impact both on the number and size of foreign banks.

The significant impact of these indicators on foreign bank entry contrasts with the rather skeptical appreciation of the impact of GATS on financial liberalization from previous qualitative studies (see for example Sorsa (1998), and Qian (2000)). Disillusionment with GATS stemmed from the fact that the negotiations failed to result in significant financial liberalization. 'The contribution of the GATS negotiations to actual liberalization of financial services has been subject to some debate, but there is no agreed view. Many observers to the GATS negotiations noted that the multilaterally bound financial sector policies do not correspond to applied policies, or, at the most, only consolidated existing policies (Sorsa, 1998)'. 'GATS has been less successful in the introduction of competition

through Mode 3, commercial presence. A number of groups of members showed greater probability of applying restrictions through minority equity participation and discretionary licensing to protect the position of incumbents (Qian , 2000)'.

Indeed, the main contribution of GATS seems to have been the locking in of policies/practices in the participant countries: 'Multilateral binding of financial sector liberalization should ensure that countries will not backtrack on commitments without due consultation with their trading partners. The multilateral dispute settlement system is also available for participants to resolve their differences' (Sorsa 1997).

The importance of the political value of GATS, though, must not be underestimated. According to these results liberalization under GATS significantly affects foreign bank presence even after controlling for the national policies of those countries that underwent the most striking unilateral reforms in the 1990s.

With regard to regional integration three RIAs significantly increase intra-bloc FFDI: Mercosur, ASEAN and the expected enlargement of the EU.

The marginal effect of the intra-bloc parameter for Mercosur[5] is 0.69, indicating that the probability of banks from other member states establishing subsidiaries within the bloc is about 100% higher than expected from the overall explanatory variables. The combined effects of membership and national policies means that the probability of finding, for example, a Brazilian bank investing in Argentina is $[exp((0.69+1.82+0.82)-1)*100]$ almost 27 times larger than expected.

This is not to say that intra-Mercosur FFDI is 100% higher than expected or that there are in Argentina 27 times more Brazilian banks than foreign banks from the rest of the world. What these results show, rather, is that because of the agreement intra-Mercosur FFDI is significantly larger than expected given the characteristics of these countries. Yet the additional effect of the Mercosur agreement does not seem to have taken place at the expense of FFDI from the rest of the world. With the exception of Paraguay, unilateral liberalization has resulted in significant FFDI from all sources in each of the Mercosur members.

In contrast with Mercosur, ASEAN is resulting in significant intra- FFDI at the expense of foreign bank entry from the rest of the world. The marginal effect of ASEAN on intra-bloc FFDI is an 110% increase in the probability of foreign bank entry from other member states. At the same time, the probability of finding foreign banks from all sources in Malaysia and the Philippines, is significantly less than expected given these countries general characteristics. In other words, preferential liberalization is resulting in the regional concentration of foreign ownership.

An important concern that arises from this development is that regional concentration of ownership may make the system more, rather than less vulnerable to local cyclical conditions. Indeed, one of the possible downsides of FFDI, is that foreign banks may

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[5] The dependent variable was entered in logs, so the percentage equivalent for a dummy is $[(exp(dummy coefficient)-1)*100]$.

transmit shocks either through 'common lender' effects, or through volatile lending determined by foreign cycles. If the empirical evidence on the importance of either of these channels is disputed, there seems to be an agreement with regard to the desirability of diversified foreign ownership.

With regard to the EU, the results show a negative albeit not significant coefficient for intra-EU FFDI. This 'perverse' effect of the EU on banking competition has been signaled before (see, for instance Gardener et. al 2000). The strategic response of European banks to the threat of competition implied by the Single Market has been a significant consolidation at the national levels so that competition has in fact decreased as a result of integration.

With the inclusion of the accession countries, however, the parameter turns positive and significant. The expected accession increases the probability of foreign bank entry in these countries a 10% above the expected levels. This tame impact, as compared to the effect on FFDI of other blocks, may be reflecting the relative 'weakness' of the announcement effect on foreign banks decision to enter the area. Actual entry may change this picture.

Finally NAFTA appears to have a neutral effect of intra-bloc FFDI. In other words, the main determinants of US banks penetration in Mexico are Mexico's level of development and openness, the two countries' proximity and the Mexican banking sector characteristics.

4. Conclusions

In the 1990s most developing countries embraced open trade and investment regimes. At the multilateral level, by 1997 61 developing countries had ratified their commitments under the GATS agreement on financial liberalization aiming, mostly, at attracting foreign banks to their territories.

Observers of the multilateral GATS negotiations have been skeptical with regard to the agreement's impact on financial liberalization. Yet, despite of the flaws of the negotiations and of the cautious and restrictive bindings finally ratified, liberalization under GATS has had an important impact on foreign bank entry. This result holds even after controlling for unilateral liberalization in those countries that went through the most striking unilateral openings of their financial sectors in the 1990s. The fact that the agreement precludes backtracking without consultation, that it offers a dispute settlement mechanism, or simply that it results in increased transparency of national legislation, increases the attractiveness of participating countries in the eyes of foreign investors.

Despite of this effect, countries seem to be wary of multilateral liberalization or at any rate are also devoting significant efforts to achieving preferential liberalization. Their success in attracting foreign investors through the regional route has been mixed. Among the developing countries the main winners of the recent wave of financial globalization have been the Mercosur and the EU accession countries. In the case of Mercosur, the combined effect of national policies and the regional agreement has meant a significant increase of foreign bank entry from all sources in Argentina, Brazil and Uruguay. The smallest country of the Agreement, Paraguay, has benefited from intra-bloc FFDI if not from FFDI from the rest of the world.

With respect to the accession countries, the announcement effect on FFDI from other European countries has been strong enough to reverse the negative impact of intra-bloc FFDI within the EU. If credibility matters, actual entry should result in much larger levels of foreign bank entry within this group of countries.

In the case of ASEAN the relation between FFDI and unilateral and preferential liberalization, however, rises some concerns. The cautious liberalization towards the rest of the world, coupled with the regional facilitation of intra-bloc FFDI is resulting in a strong FFDI diversion that could limit the region's ability to profit from globalization. As entry barriers in these countries go down at the multilateral but especially at the preferential level, the vacuum left by uninterested, or unwelcome, OECD banks is being filled by other regional banks. Although the ASEAN countries should benefit from the increase in competition, the net gains to these countries will depend on the relative efficiency of the regional banking systems, and the distance between these countries national regulations and their social optimal standards of regulation. If these countries standards of regulation differ from the optimal standards, and if the most efficient suppliers are durably deter from entry, preferential liberalization may lock the ASEAN countries banking systems in suboptimal levels of development. Another important concern is whether regional concentration of ownership makes the system more rather than less vulnerable to local cycles.

Table 1._Countries in the sample, RIA membership, Number of banks and Share of Foreign ownership._

RIA Membership	Country	Total No.Banks	Share Foreign No.(%).	Share Foreign Asst. (%)
NAFTA	Canada	56	53.6	5.60
	Mexico	46	52.2	54.35
	USA	723	9.3	10.25
EU	Austria	127	35.3	56.61
	Belgium	135	40.0	7.79
	Denmark	101	29.4	28.56
	Finland	34	37.5	73.84
	France	210	36.2	11.84
	Germany	215	31.6	5.62
	Ireland	63	76.0	37.45
	Italy	319	9.4	2.45
	Netherlands	140	48.3	8.28
	Portugal	37	30.6	18.19
	Spain	83	41.0	4.01
	Sweden	42	12.5	11.65
	UK	595	80.0	17.11
Accession	Bulgaria	22	54.5	89.14
	Czech Rep.	22	69.6	93.20
	Hungary	31	87.1	75.06
	Poland	37	73.9	85.19
	Romania	25	64.0	44.82
	Slovak Rep.	16	77.8	84.65
Mercosur	Argentina	64	56.3	73.39
	Brazil	121	52.1	41.33
	Paraguay	22	59.1	75.58
	Uruguay	30	66.7	40.47
Andean Comm.	Bolivia	12	41.7	29.60
	Colombia	35	20.0	17.05
	Ecuador	32	18.8	8.94
	Peru	18	47.1	65.11
	Venezuela	53	17.0	33.32
ASEAN	Malaysia	51	23.5	19.27
	Philippines	29	13.8	7.84
	Singapore	105	57.1	6.15
	Thailand	18	3.3	5.91
Other Countries	Australia	125	68.6	9.69
	Chile	23	60.9	40.41
	Costa Rica	27	18.5	15.52
	Dominican R.	32	12.5	5.83
	Egypt	30	12.1	5.09
	Honduras	20	10.0	2.47
	Israel	31	7.7	1.00
	Japan	353	6.2	0.35
	Korea, Rep.	20	0.0	0.45
	Panama	62	56.5	64.91
	South Africa	59	18.5	15.69
	Tunisia	18	15.8	22.15
	Turkey	41	4.8	1.64

Table 2: Tobit estimates of foreign bank presence : Dependent Variable is Lof(FFDI+1).

|	ASSETS			NUMBER		
	Coef.	Std. Err.	Signif	Coef.	Std. Err.	Signif
GDP	0.114	0.086		0.365	0.113	**
GDPPC	0.243	0.228		-0.034	0.300	
OPEN	0.548	0.182	**	1.188	0.236	***
KCONTROL	-0.187	0.113	*	-0.096	0.146	
DIST	-0.119	0.060	*	-0.259	0.078	**
ADJ	0.685	0.146	***	0.930	0.197	***
LANGUAGE	0.492	0.111	***	0.501	0.151	**
M2	0.294	0.095	**	0.557	0.126	***
INFLATION	-1.760	1.518		-2.970	2.007	
TAXF	-0.870	0.275	**	-1.016	0.366	**
ROAA	0.641	0.164	***	0.711	0.191	***
CONCEN	-1.899	0.398	***	-1.979	0.512	***
GATS1	0.638	0.298	*	0.957	0.400	*
GATS3	0.982	0.526	*	1.525	0.714	*
EU15	-0.220	0.147		-0.194	0.192	
NAFTA	-0.199	0.333		-0.440	0.453	
MSUR	1.031	0.560	*	2.010	0.759	**
ANDEAN	0.786	0.780		1.711	1.044	
ASEAN	1.220	0.558	*	1.539	0.754	*
BRAZIL	3.101	0.367	***	4.195	0.500	***
ARGENTINA	1.986	0.367	***	2.635	0.500	***
URUGUAY	2.260	0.525	***	3.516	0.722	***
PARAGUAY	0.888	0.465	*	0.935	0.664	
MEXICO	-0.170	0.328		-0.181	0.444	
COLOMBIA	1.498	0.550	**	2.200	0.729	**
BOLIVIA	-1.042	0.465	*	-1.238	0.623	*
ECUADOR	0.615	0.732		1.118	0.996	
PERU	0.642	0.627		1.040	0.873	
VENEZUELA	2.478	0.644	***	3.491	0.868	***
SINGAPORE	0.019	0.556		0.227	0.727	
PHILIP	-1.053	0.681		-1.682	0.920	*
MALAY	-0.254	0.450		-1.000	0.597	*
CZC	0.124	0.508		-0.828	0.725	
HUNGARY	1.169	0.404	**	1.125	0.567	*
BULGARIA	3.368	1.881	*	4.852	2.495	*
POLON	1.614	0.373	***	1.590	0.519	**
ROMAN	2.611	1.076	*	3.289	1.433	*
Const.	-7.994	1.742	***	-12.140	2.303	***
Pseudo R2	0.410			0.390		
Number of Obs.	2127.00			2127.000		
Uncensored Obs	350.000			350.000		

(Source dummies not presented)

Table 3: Tobit estimates of foreign bank presence : Dependent Variable is Lof(FFDI+1).

	ASSETS				NUMBER			
	Coef.	Std. Err.	Signinf	Marginal Effect	Coef.	Std. Err.	Signinf	Marginal effect
GDP	0.136	0.087		0.020	0.377	0.114	**	0.064
GDPPC	0.129	0.230		0.019	-0.116	0.302		-0.020
OPEN	0.449	0.184	*	0.067	1.099	0.239	***	0.188
KCONTROL	-0.146	0.114		-0.022	-0.058	0.147		-0.010
DIST	0.096	0.069		0.014	-0.090	0.089		-0.015
ADJ	0.790	0.150	***	0.150	1.007	0.201	***	0.214
LANGUAGE	0.576	0.114	***	0.101	0.576	0.155	***	0.110
M2	0.220	0.094	*	0.033	0.494	0.126	***	0.084
INFLATION	-1.208	1.513		-0.181	-2.505	2.007		-0.428
TAXF	-0.840	0.278	**	-0.126	-0.989	0.369	**	-0.169
ROAA	0.725	0.179	***	0.109	0.741	0.199	***	0.127
CONCEN	-1.794	0.406	***	-0.269	-1.912	0.518	***	-0.327
GATS1	0.851	0.301	**	0.128	1.125	0.404	**	0.192
GATS3	1.035	0.532	*	0.155	1.574	0.720	*	0.269
EU07	0.570	0.162	***	0.094	0.455	0.208	*	0.082
NAFTA	-0.058	0.333		-0.009	-0.320	0.455		-0.051
MSUR	1.342	0.557	*	0.321	2.264	0.760	**	0.691
ANDEAN	0.911	0.774		0.186	1.812	1.043	*	0.488
ASEAN	1.664	0.559	**	0.451	1.880	0.760	*	0.516
BRAZIL	2.966	0.368	***	1.206	4.075	0.502	***	1.821
ARGENTINA	1.965	0.369	***	0.575	2.582	0.502	***	0.825
URUGUAY	2.292	0.523	***	0.764	3.525	0.723	***	1.439
PARAGUAY	0.906	0.464	*	0.184	0.936	0.664		0.200
MEXICO	-0.179	0.330		-0.026	-0.195	0.447		-0.032
COLOMBIA	1.542	0.560	**	0.388	2.183	0.735	**	0.633
BOLIVIA	-0.989	0.466	*	-0.114	-1.209	0.625	*	-0.162
ECUADOR	0.304	0.727		0.050	0.863	0.995		0.179
PERU	0.601	0.626		0.110	1.002	0.874		0.218
VENEZUELA	2.155	0.639	**	0.699	3.254	0.867	***	1.274
SINGAPORE	0.443	0.562		0.076	0.594	0.736		0.115
PHILIP	-0.997	0.683		-0.113	-1.619	0.924	*	-0.200
MALAY	-0.048	0.456		-0.007	-0.829	0.602		-0.120
CZC	0.388	0.501		0.066	-0.639	0.716		-0.095
HUNGARY	1.252	0.398	**	0.289	1.192	0.562	*	0.271
BULGARIA	2.600	1.878		1.004	4.261	2.501	*	2.110
POLON	1.507	0.374	***	0.383	1.518	0.521	**	0.376
ROMAN	2.043	1.084	*	0.640	2.835	1.446	*	1.005
Const.	-8.647	1.782	***		-12.581	2.347	***	
Pseudo R2	0.414				0.397			
Number of Obs.	2127.00				2127.000			
Uncensored Obs	352.000				352.000			

(Source dummies not presented)

Graph 1 Qian Index of GATS1
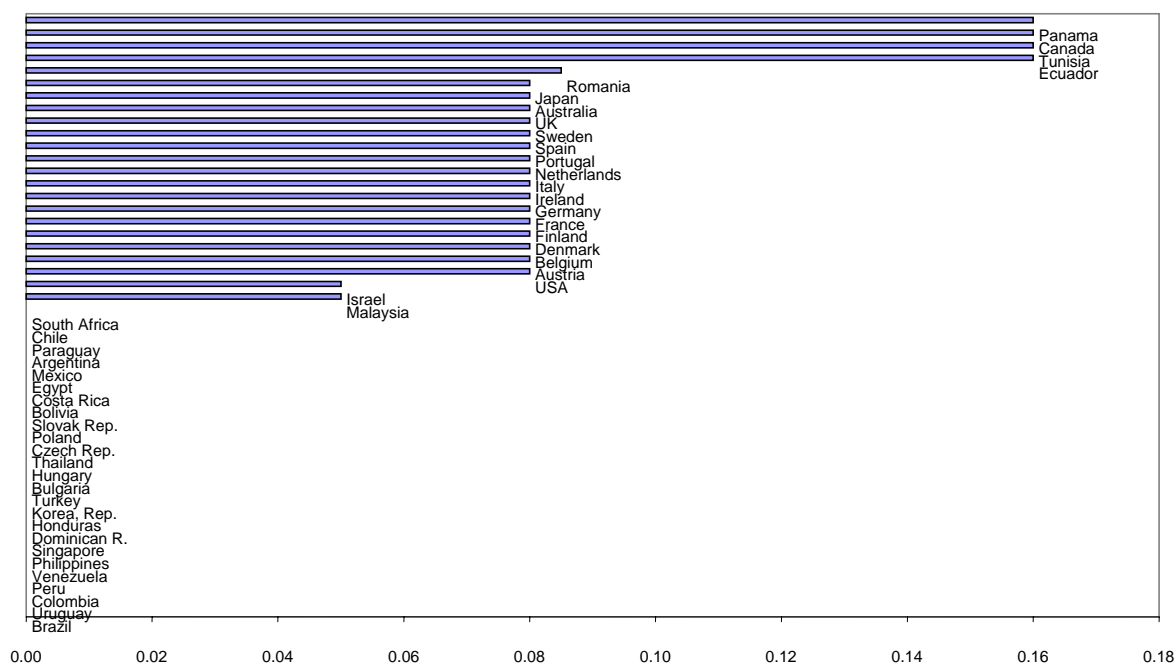
Graph 2 Qian's Index of GATS3
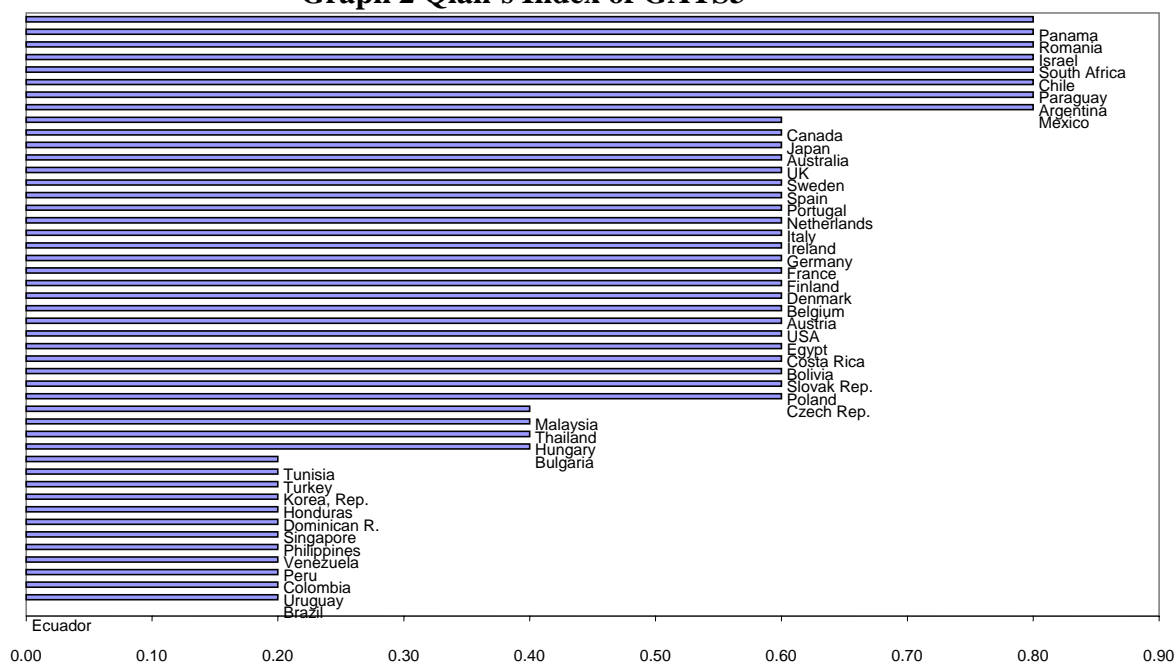
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