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Introduction

One of the more noteworthy financial developments in developing countries of the past decade is the enormous growth of foreign direct investment (FDI): from $36 billion annually in 1991 to $173 billion in 1997, according to the World Bank's 2001 *Global Development Finance* report. Although the growth in FDI flows cooled off somewhat after the Asian, Russian, and Brazilian financial crises of 1997–98, in 2000 they still stood at an estimated $178 billion, not only higher than before these crises but well above the level at the beginning of the decade.

Given the importance of finance to economic growth, it is natural to ask how important FDI has become in that particular sector in emerging market countries, what benefits and costs have been associated with it, and what changes in policy toward foreign financial firms would be in the economic interests of developing countries in the years ahead. Another important issue facing these countries is how not to be left behind by the coming wave of e-finance that some say will revolutionize financial sectors in both advanced and developing countries.

These were the questions posed at the third annual conference on emerging markets finance conducted by the World Bank, the International Monetary Fund (IMF), and the Brookings Institution on April 19–21, 2001, in New York and attended by 170 financial experts and policymakers from around the world. This volume brings together the papers presented at the conference and provides a summary of two panel discussions: one by representatives of various large foreign financial institutions with operations in emerging markets, the other by experts in the burgeoning field of e-finance.

Among other things, the following chapters confirm the rising presence of foreign firms in financial sectors in key parts of the developing world, although Asia and Africa still lag significantly behind other emerging markets in this respect. In a number of countries, the foreign presence has increased from less than 10 percent to 50 percent or more within the past decade. The chapters also document the important benefits foreign firms bring to the markets they enter: added investment; cutting-edge technologies and managerial practices (especially risk management); and, because they tend to be more diversified than local institutions, more financial stability. At the same time, the globalization of finance raises new policy issues that must be addressed, most prominently the coordination of regulation and supervision across national borders.

On balance, however, foreign financial institutions provide net benefits to the countries in which they invest. For this reason alone, it is in the interest of countries that now restrict foreign entry in some form to drop those limitations, whether unilaterally or through multilateral negotiations. A crucial issue is how best to sequence that liberalization. What are the regulatory practices that need to be put in place? Should domestic financial institutions be made solvent first? This has been a particularly difficult problem in many economies that were formerly centrally planned, where state-owned banks held a large portfolio of nonperforming loans. Although conference participants did not settle the sequencing issues, several of their comments generated an animated discussion of the topic. Many argued that waiting until domestic institutions' problems were settled before opening up was a recipe for endless delay.

How Important Is Financial Sector FDI?

As Donald Mathieson and Jorge Roldos of the IMF point out in chapter 2, entry by foreign firms in the financial sectors of emerging markets increased significantly during the 1990s, especially in banking. In the Czech Republic, Hungary, and Poland, foreign ownership of banks (including banks that were at least 40 percent owned) rose from an average of 14 percent in 1994 to 57 percent in 1999. A similar trend occurred in Latin America, where by the end of the decade foreign banks accounted for 40 percent or more of the banking systems of Argentina, Chile, and Venezuela. Foreign bank penetration remains far lower in Africa and Asia, although even in Asia, it increased markedly during this period (from 1.3 percent to 13.2 percent).

What accounts for these increases? Banks in source countries, mainly in the developed world, have pushed outward into emerging markets by and large in search of higher profits. There is another reason: foreign banks have followed corporate customers that have opened foreign operations. This, in fact, was the reason Deutsche Bank was founded in the nineteenth century, with its original four offices in Shanghai, Yokohama, London, and Bremen. But banks cannot expand abroad unless destination countries let them in. Over time, many emerging market governments have taken this course. Since the early 1990s, Mathieson and Roldós report, attitudes toward foreign banks and other financial firms have experienced a sea change in much of the developing world arising out of periodic financial crises, or in the case of Eastern Europe, because new governments learned that formerly state-owned banks were in effect bankrupt. Foreign banks have been welcomed to help reduce the costs of resolving these financial problems.

For the most part, foreign banks have helped increase the competitiveness and efficiency of the domestic banks in the markets they have entered. The results are reflected in lower operating costs and smaller margins between interest rates on loans and deposits, not just among the foreign banks but among domestic banks as well. Mathieson and Roldos do not believe the verdict is as clear, at least not yet, as to whether foreign banks have contributed to more stability. In certain cases, foreign banks have pulled out in times of trouble, and in others they have remained. Nor do the authors find unequivocal evidence that foreign banks have reduced market volatility or increased the availability of credit to local borrowers.

Nonetheless, there is some evidence to suggest that most retail foreign banks have not pulled back from emerging markets hit by financial crisis. Where they have done so, it has been due more to problems in their home countries (especially Japan). The latest proposed Basel capital standards—which, if adopted, are scheduled to become effective in 2005—may encourage foreign banks to pull back from emerging countries in the future, however. This is because the proposed standards rely heavily on ratings agencies to determine how much capital international banks must maintain for various types of loans. In the aftermath of financial crises in particular countries, ratings agencies tend to lower their ratings on all emerging market debt simultaneously, and this could curtail bank lending in these markets across the board.

Foreign banks have not been the only financial firms to wade into emerging markets in recent years. In chapter 4, Harold Skipper of Georgia State University documents a similar, although less extensive, trend among foreign insurers. Insurance, Skipper explains, is important to economic development because it spreads the cost of risk, promotes economic stability for both families and firms, and mobilizes savings. Nonetheless, insurance in emerging markets remains less well developed than banking, especially in property-casualty lines, although life insurance is significant and rapidly growing in Southeast Asia, South Africa, and other selected countries where savings rates are high and public pension systems are weak or nonexistent. In several Asian countries, foreign insurers now account for about half of the life market, and a bit less of property-casualty, despite various noninstitutional and cultural barriers to foreign firms. Like foreign banks, Skipper reports, foreign insurers tend to have stimulated improvements in productivity in the markets they have entered. Moreover, the importance of internationalizing insurance risks is illustrated by the sinking of the forty-story Petrobras oil platform in Brazil in 2001, a facility that produces 6 percent of the country's entire national oil output. No one country's market can provide cover for such loss exposures.

Still, many emerging markets maintain some restrictions against foreign insurers, with only four countries having committed to "full liberalization" under the General Agreement on Trade in Services (GATS) implemented as part of the Uruguay Round trade agreement of 1995.

What Do Foreign Financial Institutions Do in Emerging Markets?

It is important in designing policy regarding the entry of foreign financial institutions to understand what lines of business they tend to emphasize. Michael Pomerleano of the World Bank and George Vojta of the Financial Services Forum examine the behavior of the largest multinational or global banks in chapter 3. These institutions are capable of offering cutting-edge wholesale and retail services, generally at lower cost than purely domestic banks. Allowing such institutions to enter a market brings much greater competitive pressure on local banks to consolidate and reach a scale at which they can effectively compete.

At the same time, as Thomas Fischer of Deutsche Bank also confirms later in this volume, global banks tend to concentrate on the largest corporate customers that have the greatest need for their sophisticated services (including foreign exchange and risk management, derivatives trading, underwriting of securities, and cross-border mergers and acquisitions). Although local banks worry that the global banks will run them out of the business of lending to individuals and small and medium-sized enterprises (SMEs), these concerns have proved to be unfounded. As a result, global banks tend to complement—and not substitute for—the banking services of the locally oriented institutions. Moreover, for countries that have experienced banking problems, foreign institutions help in restructuring, either through outright purchases or joint ventures and alliances.

There is a dichotomy in the operations of large foreign banks in emerging markets, however. Some large multinational banks—the local subsidiaries of Citibank, HSBC, and Standard Chartered—have developed strong and profitable local franchises with a wide range of services. Others, including JPMorgan-Chase and Deutsche Bank, are much more selective and in some cases are narrowing their activities in emerging markets, refocusing on investment banking and private banking activities.

Ranjit Singh (a member of the Securities Commission in Malaysia and chairman of an emerging markets securities market working group of the international organization of securities regulators, IOSCO), Attila Emam, and Kar Mei Tang present the results of a similar study of foreign entry into the securities business in chapter 5. They find that developing countries have become more welcoming of foreign firms in this business because they see the need to finance their nonfinancial enterprises and feel pressure to liberalize under the GATS. Singh and his colleagues also report the preliminary results of a survey of foreign firms operating in seventeen emerging markets, of which nine (including nearly all Asian countries in the sample) explicitly allow foreign majority ownership of domestic securities firms (and seven allow 100 percent ownership). The survey broadly revealed that foreign firms did not "run" from—and in some cases actually increased—their participation in local markets that had suffered financial crises. As for securities exchanges, in four of the seventeen markets at least one of the exchanges had been demutualized, a trend now evident among security exchanges in developed countries (as discussed by Benn Steil in chapter 11)—and another four are looking to do the same soon.

In chapter 6, Paul Masson summarizes the experiences of several financial institutions already involved in emerging markets. One such institution is the International Finance Corporation (IFC), which has made broad investments in private firms in emerging markets. Half of these are in domestic banks and the rest in private equity, venture funds, asset-based financing, and other related activities. In the IFC's view, financial institutions arise in response to the development of a middle class in emerging markets. The IFC has concentrated its investments in building secondary markets for mortgages to encourage home ownership, promote various savings vehicles (pension plans, insurance, and contractual savings systems), and facilitate retail banking, which, as Pomerleano and Vojta document in chapter 3, is still largely the province of domestic banks in these markets. Although Latin America is the IFC's largest region, the institution views Africa as a potentially large market, as liberalization and privatization proceed in that part of the world.

By contrast, Deutsche Bank's emerging markets strategy has historically concentrated on Asia. The bank located there in order to follow its corporate customers and plans to continue that function. Though it provides full banking services and has an extensive local presence, after the experience of the Asian crisis it no longer tries to compete with local banks in collateralized lending to smaller companies. Another global investment firm, Goldman Sachs, has found that technology makes it possible to avoid having to establish a major local presence in most emerging markets. Through New York or a limited local office, Goldman Sachs is able to offer global products for which it has a comparative advantage. The firm has become a leading underwriter of sovereign and corporate bonds issued from emerging markets, and non-U.S. activities now account for more than half of its revenues.

AIG, a global insurer founded in Shanghai, also has strong Asian roots. In addition to pursuing worldwide insurance activities, the company has recently sponsored more than twenty investment funds with assets in emerging markets. Unlike some other fund sponsors, AIG provides roughly 10 percent of the capital of each of the funds it sponsors, looking to exit (like the IFC) through initial public offerings and sales either to strategic buyers or to local managers. At AIG, a decision to invest depends on several aspects of the local environment: macroeconomic stability, a promarket orientation, rule of law, and transparency of government bodies and regulations.

Regional Case Studies

Three chapters in this volume outline the experiences of countries and regions that have recently welcomed significant foreign investment in their financial sectors. The Czech Republic, as Donald Simonson of the University of New Mexico notes in chapter 7, privatized its formerly state-owned banks in the early 1990s but initially restricted share purchases by large foreign banks, hoping that Czech ownership would evolve. Emphasizing fairness toward its citizens, the government gave them vouchers, which maintained domestic ownership. Foreign interest was also deterred by the absence of effective legal support for creditors: weak laws and judicial administration. By the end of the decade, however, the main Czech banks were paralyzed by large holdings of nonperforming loans, so the government turned to foreign banks to mount a rescue and strengthened bank supervision by adopting international standards. Today, the Czech banking sector is significantly stronger and more competitive as a result.

In chapter 8, Jennifer Crystal, B. Gerald Dages, and Linda Goldberg of the Federal Reserve Bank of New York report similar positive results from the rapid increase in foreign ownership of banks in Latin America during the 1990s. For the most part, the team finds that local banks acquired by foreign owners became financially stronger in comparison with their domestic counterparts. Foreign banks in Argentina, Chile, and Colombia demonstrated higher and more stable average loan growth and higher risk-based capital ratios. Surprisingly, however, their profitability was only comparable to or weaker than that of domestic banks. This latter finding, coupled with the fact that foreign banks had higher loan loss provisions than domestic competitors during the period studied, suggests to the authors that foreign banks have not "cherry-picked" their loan customers but instead have taken more aggressive actions to deal with bad loans when they deteriorate. On average, the foreign institutions also did not "cut and run" when certain Latin American countries encountered financial difficulties during the decade. Because large-scale foreign ownership is a fairly recent phenomenon emerging in a rather inhospitable macroeconomic environment, however, the authors think it may take more time to gauge the true competitive dynamics of increased foreign ownership.

Chapter 9, by Nicholas Lardy of the Brookings Institution, focuses on China, where until recently foreign financial firms of all types have been subject to significant restrictions. Nonetheless, over 100 foreign banks with offices in China are poised to expand as China meets the conditions to which it agreed in order to become a member of the World Trade Organization (WTO). Some of these firms also may be in a position to help ease the cost of dealing with China's large problem of nonperforming loans now held by its state-owned banks (or transferred to asset management companies for resale). Still, Lardy expects that foreign bank expansion will be a slow undertaking in China for at least two reasons. One is that the government continues to limit the ratio of a foreign bank's domestic to foreign currency deposits. Even when this restriction is fully lifted, Lardy points out, there will be a shortage of creditworthy (by Western standards) domestic borrowers. Foreign insurance companies are also likely to enter China fairly slowly because, unlike banks, which expect to have all ownership restrictions eventually lifted as part of China's planned accession to the WTO, foreign insurers will continue to be limited to no more than a majority ownership interest. Even tighter restrictions will continue in the securities and fund management industries. Thus foreign financial institutions are unlikely to take a major role in the near future in the necessary process of modernizing China's financial sector.

Future Policies toward Financial Sector FDI

Like several other contributors, Edward Graham of the Institute for International Economics argues in chapter 10 that allowing foreign firms freely into financial activities appears to have overwhelming economic benefits. More controversially, Graham claims that this should happen even in countries experiencing financial problems, despite fears that foreign institutions could then destroy weak domestic competitors. If these fears constitute a significant political constraint, Graham suggests that governments could condition foreign entry—during some transition period—on acquiring weak or insolvent domestic institutions. In addition, countries fearing domination by foreign firms from one particular country (where financial difficulties may cause them at some time to pull back from activities abroad) could seek to diversify source country owners to address this concern. But maintaining existing investment restrictions can only deepen the cost of resolving a financial crisis, while penalizing potentially creditworthy borrowers who might otherwise not be able to obtain loans from the existing troubled banks or other financial institutions. Of course, countries that have strong domestic financial systems but nonetheless continue to restrict foreign entry have no good economic excuse for doing so, in Graham's view.

Two other factors of great potential importance to developing countries, as Benn Steil of the Council of Foreign Relations notes in chapter 11, are the technological advances that would sharply reduce financial transactions costs and the development of liquid and efficient securities markets. These changes have led to radical declines in the need for exchange intermediaries and hence have led to the restructuring of securities exchanges in advanced countries. As a result, exchanges in advanced countries have tended to demutualize and to be incorporated instead. Steil argues that since the costs of introducing trading systems and central securities depositories have already been incurred abroad, developing countries should import these technologies rather than start from scratch.

Moreover, given the large cost savings made possible by electronic networks, Steil advises emerging markets to abandon the traditional mutual exchange model—one that relies on floor broker-members to complete transactions as intermediaries on behalf of others—and to move instead to the vastly cheaper, privately owned electronic networks to facilitate the trading of securities. The listing of securities, which should be a competitive business open to nonexchanges subject to perhaps minimum government standards, can and should be separated from the infrastructure of trading itself, which, given the extraordinary advances in information technology, can be contracted out (as can settlement of trades, which need not be tied to the systems used to execute the trades). Often, the best contractors will be foreign.

Steil also urges emerging market exchanges not to feel compelled to provide continuous trading. For lightly traded stocks where liquidity may be a problem, the solution lies in periodic call auctions in which bids are cumulated and prices are set several times a day. Indeed, Steil notes that the Warsaw Stock Exchange started out with one call auction *per week*.

Much of the progress toward liberalization of foreign restrictions in the past has been in the context of multilateral negotiations, where the relaxations are reciprocal. The most recent example is the Financial Services Agreement (FSA) concluded in December 1997 under the auspices of the GATS. In chapter 12, Pierre Sauvé of the Organization for Economic Cooperation and Development (OECD) and Karsten Steinfatt of the Organization of American States survey the prospects for further reciprocal liberalization in light of the backlash against the WTO triggered in Seattle in 1999.

On the bright side, the authors point out, financial communities in developed countries are still showing a strong interest in further progress. But they also caution that because the commitments toward liberalization of ownership and activity restrictions in the financial sector under the FSA have been in effect for only two years, it is far from clear how much appetite developing countries have for additional commitments so soon after the earlier round. Furthermore, the negotiating agenda in the financial sector is a complicated one, involving such new issues as the applicability of existing restrictions to Internet-based finance, as well as how those restrictions can be rationalized in the new world of finance, where traditional barriers between different lines of business (banking, insurance, and securities) are becoming less relevant elsewhere around the world. Sauvé and Steinfatt conclude that the best chance for further reciprocal liberalization would be a new broad round of WTO negotiations launched by OECD governments that would afford ample opportunities for trade-offs between liberalizations in financial and nonfinancial arenas. In the meantime, they view the gradual development of international standards for financial supervision as a useful way of locking in measures to maintain competition in financial markets.

However rapidly current restrictions on foreign direct investment may be removed, governments both in emerging markets and in developed economies that are home to many global financial institutions also face a new set of policy challenges associated with the increased globalization of finance. As Mathieson and Roldós note in chapter 2, it is essential to maintain and implement antitrust policies to prevent undue concentration of their financial systems, especially where foreign firms are successful in driving out local competition. All countries also need to improve cross-border coordination of financial supervision, regulation, and the sharing of confidential information. At the same time, say various contributors, regulators in emerging markets can benefit from the risk mitigation and other managerial skills that foreign financial institutions bring with them when they enter these markets. Graham adds that strengthening domestic supervision is especially important after a crisis if bank deposits have been legally or de facto protected against loss. Otherwise, such guarantees can lead to a significant "moral hazard" by encouraging imprudent lending behavior and thus may lay the groundwork for future crises.

The Role of Financial Sector E-Commerce

The e-commerce revolution sweeping across many developed countries is also making its presence felt in emerging market countries and others that are nearing developed-country status. Indeed, South Korea and Singapore are considerably ahead of much of the developed world in the percentage of the population online. Mobile telephones, which will be used more and more to access the Internet, also are rapidly penetrating parts of the developing world. Still, e-commerce in emerging markets is by and large far behind that of the developed world. Will this change?

Philip Turner of the Bank for International Settlements is optimistic that it will, although the change will be gradual in many emerging markets because their telecommunications infrastructure is typically weaker than in the developed world. As Turner observes in chapter 13, the Internet is more than just an evolutionary development; it promises a revolution. Furthermore, the Internet's impact on financial systems is very uncertain at this point, and the need for infrastructure support for online activities will be massive. What this means for the competitive position of local banks in developing countries is unclear. At the same time, e-finance undoubtedly will have a far-reaching effect on the financial systems in emerging market countries. Although it is also likely to increase operational risk in the financial sector, regulators must try to be flexible in responding to technological changes. It will be essential to monitor service providers and not just financial firms and to enhance international regulatory cooperation, since the Internet respects no national boundaries.

In chapter 14, four comments on Turner's chapter extend his analysis in several respects. Thomas Glaessner of the World Bank, for instance, calls on telecommunications authorities around the world to prevent their incumbent telephone monopolies from refusing interconnection with other providers and from charging excessive rates for doing so. Nonetheless, assuming these difficulties eventually are overcome, the substantial gains in efficiency promised by the Internet—banking transactions costs can be reduced by a factor of 100, which banks in some countries, such as Brazil, are exploiting—suggest its increased penetration is inevitable. But as this happens, policymakers in both the developed and developing world will face new challenges: most notably, they will have to learn how to monitor operational risks of institutions that use the Internet, both for the sake of their customers and of the system (since many institutions may be using the same software); they will have to decide which country's law applies when bank transactions falter; and they must protect financial systems from the increased involvement of nonfinancial firms in finance, which the Internet makes possible.

The development of e-finance will also hinge on other factors. Both Ed Horowitz and Ed Ritscher emphasize in their comments the importance of trust on the Internet, a challenge that may be met, at least in part, by public infrastructure technology that will facilitate the authentication of parties doing business on the Internet. Financial institutions face special challenges that argue further for international rules of authentication and certification, says Horowitz. Ritscher notes that the emergence of business-to-business exchanges and the growing interest of telecommunications companies in completing payments on the Web threaten to disenfranchise banks in particular. He nonetheless believes that banks and other financial institutions can preserve their profitability by developing new business models that take advantage of the low cost infrastructure of the Internet.

Robert Ledig highlights a potential thorn in the side of Internet commerce: emerging disputes over whose laws apply to e-commerce. Ledig points to a growing tendency among developed countries at least to assert extraterritorial jurisdiction, in effect, requiring web sites either to screen out material that might be offensive to residents of different countries, or at a minimum, to tailor disclosures that are specific to these countries. A proliferation of these jurisdictional requirements could impede the growth of global e-commerce.

The overall conclusion that can be drawn from the discussions in this volume is that developments in emerging financial markets are creating tremendous opportunities for domestic and foreign firms, on the one hand, and enormous challenges for regulators, on the other. Most of the contributors believe that relaxing restrictions and attracting foreign competitors in the financial field will increase efficiency and thus encourage growth. At the same time, the entry of foreign firms and the development of new technologies (such as e-finance) may increase the level of financial sector risk and make best-practice financial supervision all the more important.