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BANKING ON MULTINATIONALS

Increased competition from large foreign lenders threatens domestic banks, raises financial instability

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Policymakers convening in Washington, D.C. this week for the joint meeting of the World Bank and International Monetary Fund will begin to implement the global agenda launched at the United Nations conference on development financing held in Monterrey, Mexico in March 2002. In recent years, declining official aid, booming foreign direct investment, and greater capital market integration have transformed the way low- and middle-income countries finance development. As a result, developing countries must now more than ever create an environment that effectively mobilizes and harnesses foreign and domestic financial resources, and the world's policymakers must find a way to structure financial systems in order to meet the UN Millennium Declaration goal of halving world poverty by 2015.

In a recently released report, the World Bank (2002) argues that changing the rules to allow greater participation of multinational banks (MNBs) in developing countries will result in the efficiency and stability needed to attract growing levels of private capital for development. While embracing investment inflows is an uncontroversial proposal, recommendations for increased international financial competition deserve careful scrutiny. Economists currently have only a limited understanding of the consequences for the real economy of increased foreign penetration of emerging financial markets. The existing evidence, however, does not tend to support the hope that increased competition from MNBs will make domestic banks more efficient or banking systems more stable. Moreover, the research shows that increased foreign competition lowers the supply of credit—especially to business start-ups, small- and medium-size enterprises, and low- and middle-income consumers—and increases the possibility for financial instability.

Why do banks go global?

Multinational banks (MNBs), by definition, are those that physically operate in more than one country. For instance, Citibank operates offices in more than 90 countries around the world. In contrast, international banks

TABLE 1
Multinational bank loans in developing countries

	MNB local currency loans ($ million)	MNB local currency deposits ($ million)
Africa & Middle East		
1985	$6,198	$5,533
1990	6,433	5,338
1995	13,560	13,046
2000	24,421	22,686
Asia & Pacific		
1985	14,432	8,474
1990	27,472	18,127
1995	56,517	38,049
2000	117,832	106,628
Eastern Europe		
1985	2,047	550
1990	2,680	1,340
1995	9,588	7,133
2000	61,375	57,526
Latin America & Caribbean		
1985	10,507	7,510
1990	15,312	12,952
1995	44,276	33,615
2000	230,540	196,980

Source: Bank for International Settlements, Consolidated International Banking Statistics.

engage in cross-border operations and do not set up operations in other countries. A Bank of America loan to a bank in Poland is considered international banking.

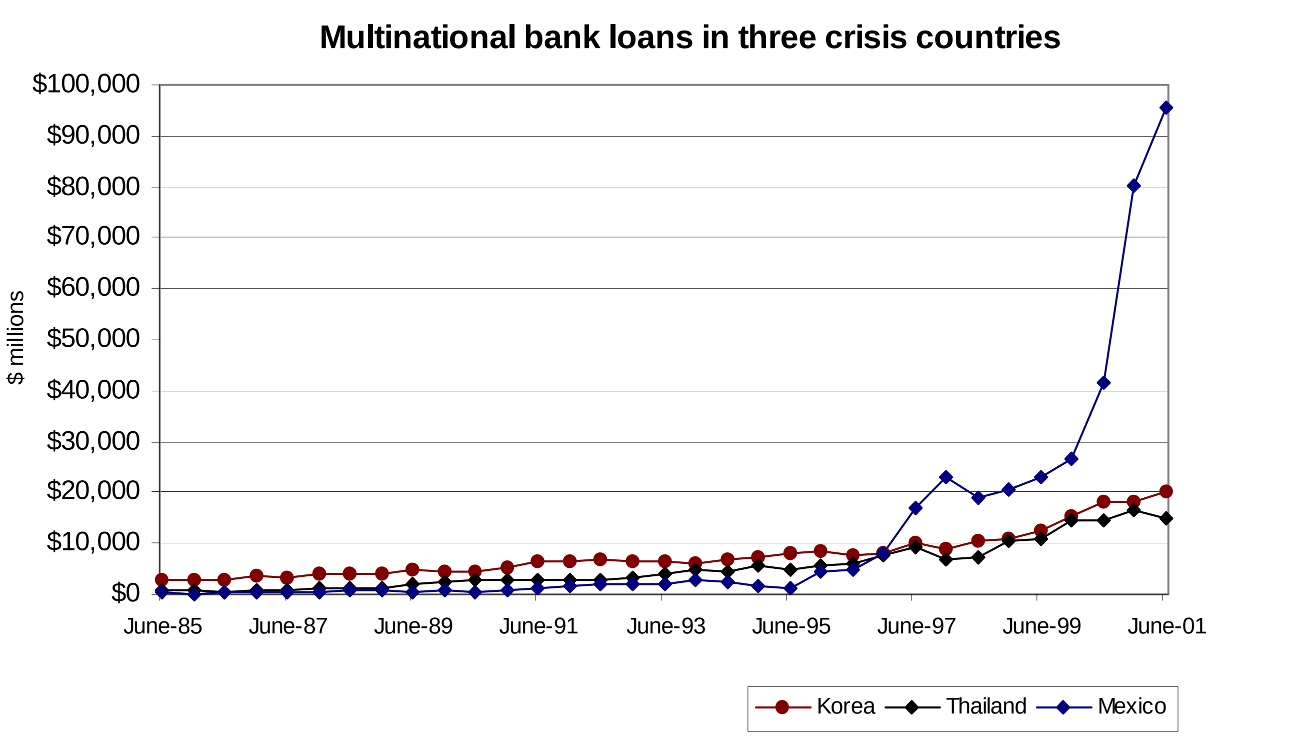
MNBs have experienced rapid growth in the past few years (see **Table 1**). Access to new markets in Central and Eastern Europe and financial deregulation elsewhere has helped to accelerate the growth of MNB operations. The most rapid growth of MNB loans has been in Eastern Europe, thanks to the opening of the former East Bloc countries. Latin America has also experienced a rapid increase in MNB loans over the years, following financial deregulation and bank privatizations. As a result of deregulation and growing financial integration, cross-border mergers and takeovers of banks grew from 320 in the 1980s to 2,000 in the 1990s (World Bank 2002). By the end of the 1990s, foreign banks controlled more than half of the banking system in many countries in Eastern Europe and Latin America (Mathieson and Roldos 2001).

The impressive growth of MNB loans does not reflect equally fast-growing capital inflows. MNBs basically work like this—they collect local currency, combine that with funds borrowed from overseas, and then lend that money domestically. Hence, MNBs are small net importers of capital, otherwise operating in a manner similar to domestic banks. Yet, even though MNBs look like domestic banks, their entry and operations are subject to international trade agreements, such as the General Agreement on Trade in Services (GATS) at the World Trade Organization (WTO).

MNBs tend to expand their global operations for two reasons. First, MNBs follow their clients. Since MNBs operate in a wide array of countries and regions, multinational corporations (MNCs) become their natural clients. When MNCs establish new operations, MNBs often follow. Second, the concentration on a small number of large clients in combination with superior technology and know-how makes MNB operations very profitable. For instance, even in the midst of high inflation and economic turmoil in Brazil in 1983, MNBs operated very profitably, with Citibank earning 20% of its worldwide income in Brazil that year. In Korea, MNBs averaged 75-80% returns on equity, whereas domestic banks earned only an average of 15-20% between 1972 and 1979. In 1991, MNB profits in Korea rose by 37% compared to 12.9% for domestic banks, leaving MNBs with a share of 68% of all net bank earnings, up from 61% in 1990.

Less-industrialized economies also have become more open to MNBs, often because of a need for international capital. MNBs are, after all, a form of capital inflow and hence help to finance current account deficits. Furthermore, countries that have undergone financial crises often look to stabilize their banks with the help of international investors by allowing MNBs to quickly expand their operations. In Korea and Thailand, MNB loans dipped briefly after the financial crisis hit, but within a year recovered and even accelerated (see **Figure 1**). A similar trend was also observed in Mexico, where MNB loans more than doubled from $1.8 billion at the beginning of the peso crisis in December 1994 to $4.3 billion in December 1995, only to jump to $8.0 billion by December 1996 (Figure 1). As investment rules in the North American Free Trade Agreement took effect, MNB loans in Mexico soared to over $95 billion. The need to find investors for troubled banks coupled with the fact that, after a rapid devaluation, domestic assets can be bought at bargain-basement prices helps explain the increase in MNB loans after a crisis.

FIGURE 1



Source: Bank for International Settlements, Consolidated International Banking Statistics.

In their operations, MNBs focus on a select range of activities for a small circle of clients. MNBs tend to provide services that other banks are either less familiar with or do not offer, such as foreign currency loans, acceptances and guarantees related to international trade, or syndicated loans. As a result, MNB clients are usually MNCs or large domestic corporations engaged in international transactions. In addition, MNBs also provide services for high-income earners, or what is referred to as high net-worth individuals.

MNBs shrink supplies of external financing and destabilize host economies

Though often heralded as a leading rationale for the role of MNBs in developing countries, the retail banking services of most benefit to domestic consumers, such as small checking and savings accounts, mortgages, or small business loans, are rarely emphasized by MNBs. In 1995, Creditanstalt, an Austrian MNB that is especially active in Eastern Europe, promoted itself as one of the few MNBs that engaged in retail banking services. However, when asked what the minimum loan size for a Creditanstalt customer in Poland would be, the answer was $100,000. Given the wage differentials between Poland and the United States, this would be equivalent to a minimum loan of more than $500,000 in the United States, well outside the range of a mass market. It is quite clear that MNBs do not serve the majority of low- and middle-income households or even small- and medium-sized enterprises and start-ups.

Even though MNBs largely serve a small, wealthy circle of clients, the logic behind greater MNB entry is that domestic banks will be forced to improve their operations in order to remain competitive. According to this logic, the resulting increase in the efficiency of domestic banks should increase the available amount of credit and improve the stability of local banks.

In practice, however, research finds that increased competition from MNBs leads domestic banks to reduce their loan exposure (Weller 2000a, 2000b; Weller and Scher 1999). Prime examples of this connection between more MNBs and less credit can be found in the economies of Central and Eastern Europe. In these areas MNBs have quickly gained significant market shares, while the credit supply, especially to smaller companies, has been stagnant or declining. The same result also holds true for a broad sample of economies in other parts of the world.

The reason that domestic banks lower their credit exposure is because MNBs "cherry pick" the best customers, leaving domestic banks with borrowers of lesser quality. As a result, both the costs and credit risks at domestic banks increase, while low-risk, low-cost customers move to MNBs.

This puts domestic banks in a bind. Thanks to increased international competition, the domestic banks inevitably need more capital to fund new technologies, to train existing workers, and to hire new banking experts. Greater international competition also means that domestic banks lose lending opportunities to MNCs and large domestic corporations — the most secure stream of income from loans — thereby making it harder for domestic banks to get the capital necessary to compete with MNBs.

Initially, the entry of MNBs leads domestic banks to reduce lending in an effort to shore up their capital-to-asset ratio. Since the most stable banks are the ones that do not lend any money, reduced lending also increases the stability of local banks, but only superficially. This appearance of stability is misleading — if domestic banks were to increase lending, then the stability of the banking sector would decline since lending would go to riskier borrowers. In reality, little has changed in that economy's banking technology or expertise that would allow domestic banks to better evaluate credit risks, primarily because the domestic banks still do not have access to the funds needed for these types of improvements. Eventually, in order to survive, domestic banks must race to capture the markets for domestic savings and credit ignored by MNBs, despite insufficient capital to expand lending. Thus, banks that shouldn't be lending more will. In the end, domestic banks may look more stable, but this is due to temporarily lower loan exposure, not efficiency gains from greater competition. Where technological progress has been made, it is often not directly relevant for the stability of the banking system (e.g., ATMs), or it is too little too late. As a result, many domestic banks either merge or are acquired by MNBs, thereby raising the foreign presence even further.

Another destabilizing impact from declining loans results from the spill-over into the non-financial sector. Businesses need bank credit for investments. If loans are reduced due to increased international competition, firms will not have enough funds for their investments. As companies become unable to invest in new technologies, their ability to compete will decline, thereby weakening the non-financial sector and eventually the financial sector. (Weller 2000a, 2000b, 2000c finds that increasing MNB loans have led to declining real credit in emerging and transition economies. Further, this decline has increased the chances for banking crises in Central and Eastern European countries.)

Finally, despite an image of soundness and stability, there is some evidence that MNBs may foster the speculative bubbles that eventually lead to financial crises while transmitting these crises to otherwise stable countries. For example, Japanese MNBs speculated in real estate in Thailand in the early 1990s in an attempt to recover the losses incurred in Japan in the late 1980s, directly contributing to the financial crisis in Thailand in 1997. A crisis in one country may induce MNBs to cut back on their local asset portfolios in another country (or to pull out altogether) to compensate for deteriorating balance sheets in other regions, thereby spreading financial instability (World Bank 2002). Thus, there is no clear evidence that MNBs finance necessarily sounder projects than domestic banks. And if the actions of MNBs force less well-capitalized domestic banks to engage in speculative operations in order to generate the profits needed to remain competitive, domestic financial systems may become less stable in the face of greater foreign competition. Through speculative behavior and the ability to transmit crises, MNBs may destabilize entire financial systems even beyond the countries in which they operate.

Proponents of MNB entry claim that domestic banks will eventually become more efficient, but this assumption is based on the erroneous notion that banking technology and know-how will somehow naturally diffuse throughout the market. MNBs have technology and banking expertise that is obviously superior to that of local banks — that is part of what makes them MNBs. As would be expected, MNBs are aware of their competitive advantage and guard their technology and knowledge closely. This case of barriers to technology transfer is supported in a number of countries, such as Kenya, with long histories of MNB presence, where few technologies have transferred to local banks. In fact, the World Bank organized a "twinning" arrangement between local banks and MNBs in Poland in the early 1990s, but the arrangement failed because neither side wanted to nurture its competitors. One of the top priorities for MNBs is to establish branch offices or wholly owned subsidiaries that share as little information as possible with other banks.

Implications for public policy

Clearly, the banking stability and efficiency needed to attract financing for development should not rest on the shoulders of multinational banks. The evidence suggests that MNBs are insufficient for diffusing efficiency enhancing technologies and knowledge to domestic banks, and their presence shrinks the supply of available credit and destabilizes host economies. For developing countries, creating an environment conducive to investment and steady, sustained growth requires a concerted effort of public policy.

If the superior performance of MNBs lies in their better technology and know-how, to gain access to these advantages host countries could impose capital controls that would require MNBs to enter into partnerships with domestic banks. For instance, MNBs could be required to establish local subsidiaries, while at the same time be prevented from owning the majority in any domestic company. Similarly, foreigners could be prevented from owning real estate, thus requiring them to seek out local partners if they want to own their branches. Such joint ventures may prove difficult to operate, however, due to different management and banking cultures and the reluctance of MNBs to share key technologies and information.

Relying on MNBs as a major force in host country credit markets will leave many sectors of the economy underserved by financial services. The entry of MNBs reduces credit available to business start-ups, small- and medium-sized enterprises, and to low- and moderate-income households—areas where more financing could have strong direct effects on employment creation and poverty reduction. As a result, public policy must explicitly address these shortcomings in credit allocation by promoting financial institutions other than MNBs, such as credit unions, postal savings banks, mortgage companies, and publicly owned banks.

On their own, the presence of MNBs at best does little to increase financial stability and at worst raises financial instability of the host country banking system. Greater instability can result from riskier lending by domestic banks and by exposing the economy to financial crises transmitted from otherwise unrelated national and regional economies. To increase financial stability, policymakers should consider selective capital controls that can protect their economies from destabilizing capital movements. In addition, multilateral actions on financial stability that include the participation of developing countries should also be promoted.

With the growing importance of private capital for development in the poor countries, there is no real substitute for the development of an efficient *domestic* banking system. Such development requires the creation of stable institutions that will allocate funds to the most desirable uses. Fostering the creation of a local banking sector requires public financial support, as the experience of several developed economies has shown. Such development requires the creation of stable institutions that will allocate funds to the most desirable uses while providing a stable foundation for sustainable growth.

This report is an update of the EPI Issue Brief, Banking on Multinationals *(April 14, 2000), and it is largely based on the findings in Weller (2000a, 2000b, 1999) and Weller and Scher (1999).*

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