Foreign Bank Participation and Crises in Developing Countries

In countries that suffered a banking crisis foreign participation increased by 7.5 to 11.3 percentage points

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Since the mid 1990s, due to a growing trend across countries towards globalization and financial integration, banking sectors in many developing countries have experienced some important transformations. Key among them has been a rapid increase in the degree of foreign bank participation. Between 1995 and 2002, the average share of banking sector assets held by foreign banks in 104 developing countries rose from 18% to 33%.

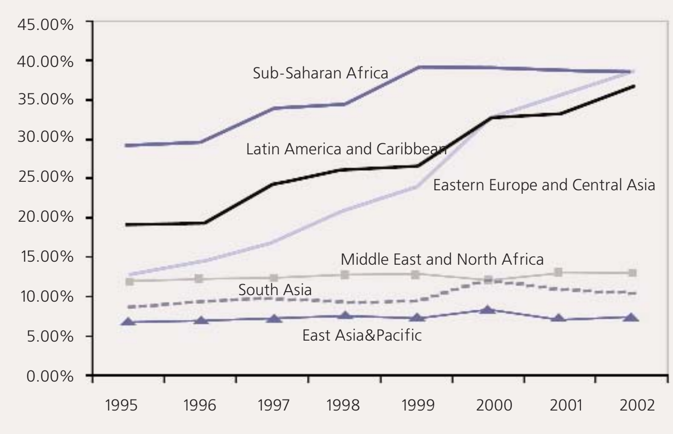
What are the causes and implications of foreign bank presence in developing countries and its links with banking crises? We explore these issues using data on the share of banking sector assets owned by foreign banks in 104 developing countries, with a special emphasis below on Eastern European and Central Asian countries (ECA).

Between 1995 and 2002, foreign bank participation increased primarily in Eastern Europe and Central Asia, Latin America, and Sub-Saharan Africa (see Figure). By 2002, close to 40% of assets in all three regions were in the hands of foreign banks. At the same time, both the absolute and relative increase in the share of assets held by foreign banks have been most significant in ECA, where it roughly tripled from almost 13% in 1995 to 39% in 2002. Latin American countries followed, with foreign bank participation nearly doubling in 2002 compared to 1995.

The entry of most foreign banks in ECA countries resulted from the privatization of state-owned banks following the fall of communism. The largest five foreign banks with operations in the region are Belgian KBC Bank, Austrian Erste Bank and HVB Group, French Societe Generale and Italian Unicredito Italiano. There are some regional specificities: large Scandinavian banks have the markets of the Baltic States, Greek banks are present in the Balkan countries, while Austrian banks control large shares of banking assets in most of the countries, except for the Baltic States.

The increase in foreign bank participation over the last decade was also quite pervasive. Out of 25 countries in ECA, the share of assets held by foreign banks increased in 22 of them (see Table). The increase was particularly spectacular in Lithuania and Slovakia, where the share of assets controlled by foreign banks rose by over 70 percentage points. Relative to the starting levels of foreign bank presence, Romania also experienced a significant increase in foreign bank participation, while in countries such as Azerbaijan, Serbia, Uzbekistan, and Turkey, it remained insignificant.

Foreign Bank Participation across Regions, 1995–2002



Data source: Micco, Panizza, and Yanez

The Catalytic Role of Crises?

Banking crises are a fact of life in developing economies. Since the mid-1990s, 77 episodes of crises have taken place in 72 developing countries, including in 21 ECA countries. Crises represent enormous challenges to policy-makers. The costs of dealing with crises, such as paying for deposit losses, recapitalizing banks, and building banking systems that are more resilient to shocks, can be very large. For example, in Turkey they amounted to 30% of GDP (in 2000-2003) and in Indonesia were as high as 55% of GDP (in 1997-2000). Moreover, most crises have macroeconomic roots and take place in environments where governments have already difficult fiscal situations. The average budget deficits to GDP three years before and three years after crises in ECA were -3.94% and -4.18%, respectively. Running budget deficits before the start of crises would hamper the governments' ability to deal with the cost of these events subsequently.

Yet, crises also represent opportunities for developing countries since they prompt governments to think differently and creatively about the problems they confront. In many developing countries, crises have encouraged governments to deregulate their banking sectors and to allow the entry of foreign banks. A measure of banking sector restrictions produced by the Heritage Foundation shows that with the exception of Asia, countries that have experienced crises tended to be more open subsequently than countries that never experienced a crisis.

Many studies have discussed the catalytic role that crises can play in promoting foreign bank participation in developing countries. Indeed, our estimations show that countries that had at least one banking crisis from 1995 to 2002 tended to have more foreign bank participation than those that did not. Our estimations show that foreign participation increased by 7.5 to 11.3 percentage points between 1995 and 2002 for countries that suffered a banking crisis.

Our results indicate that foreign banks did not reduce their participation in crisis years, moreover, there was a steep increase in foreign participation after crises had passed. This implies that foreign banks

Foreign Bank Participation in Selected ECA Countries, 1995 and 2002

	1995	2002
Europe & Central Asia	**13.0%**	**35.7%**
Bulgaria	8.2%	51.7%
Croatia	9.8%	42.1%
Czech Republic	14.2%	58.7%
Estonia	80.7%	72.7%
Hungary	22.4%	58.7%
Kazakhstan	12.6%	20.0%
Latvia	17.8%	38.8%
Lithuania	18.9%	91.3%
Macedonia, FYR	28.4%	41.8%
Poland	3.7%	49.3%
Romania	0.0%	26.5%
Russia	2.0%	15.6%
Slovak Republic	8.7%	81.5%
Slovenia	6.8%	25.8%
Ukraine	0.0%	6.8%

Source: Micco, Panizza, and Yanez (2006)
Note: Table shows the share of assets (% of total banking sector assets) held by foreign banks

could be acquiring cheap —most probably distressed — domestic banking assets as a result of crises, which could be viewed as beneficial by regulators.

Lower Private Credit Levels

Did greater participation of foreign banks coincide with increased provision of credit to the private sector? We find that in the aftermath of crises, high foreign bank participation levels are associated with lower private credit levels. Does this imply that foreign banks pull back from lending as a result of crisis? This is not necessarily the case because, as noted above, it could be that foreign banks are acquiring distressed banks with relatively weak loan portfolios. Many of those loans are written off in restructuring exercises prior to the sale of banks to foreign investors, and thus the reduction in private credit is a mechanical accounting exercise rather than a reflection of slow post-crisis credit growth.

We cannot, however, rule out the possibility that new entrants are simply poor intermediaries for the private sector. In environments where foreign banks are better established, there is no such reduction, and private credit is at higher levels before, during, and after crises. Our results support the idea that, in the aftermath of crises, better established foreign banks provide more credit to the private sector than recent foreign entrants, which have acquired distressed banks. One might also expect that the competitive pressure stemming from stable foreign participation would enhance banking sector efficiency.

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Financial Sector Development in South Eastern Europe

In transition countries in general and in South Eastern Europe (SEE) in particular, financial markets are substantially smaller than in established market economies, as measured by the financial intermediation ratio. Nevertheless, if regulations were appropriately set, effects on growth could be expected. We examine whether the development of financial markets has played a significant role for real GDP per capita growth in four SEE countries — Bulgaria, Croatia, Romania and Turkey — during 1995-2005, using a production function approach. The influence of the financial sector on the economy can be measured via total domestic financial intermediation (TFI), defined as the sum of domestic or private credit, market capitalization of domestic shares and outstanding domestic bonds.

Compared to neighboring Greece, the level of financial intermediation is still low in the four countries, with the highest level achieved by Croatia (see Table). Stock market capitalization contributes very little to financial intermediation in all countries.

The results of our estimations show that the potential contribution of the financial sector to economic growth in the four countries has not been fully used. As TFI showed rather negative effects in the short term and with lags was only mildly positive, we suggest that the different financial segments play different roles at the stage of development that these SEE countries are in. Domestic bonds stand out as maybe playing an important role in economic development for the SEE countries over the last ten years, whereas private credit and the stock market had no significant influence on growth.

The fact that government issues dominate bond markets is a salient structural feature of these markets. As previous research indicated, governments may play an important role in developing financial markets at an earlier stage of a country's development, when capital is scarce.

The insignificance of private credit might be due to the high level of bad loans to the private sector, while for the stock markets this is most probably due to their underdevelopment; both suffered from a prolonged weak legal environment during the transition years.

As for non-financial intermediation variables, only capital stock growth proved to be significant and positively related to economic growth. This could be explained by the large capital scarcity in transition countries. These capital flows stem mainly from FDI, with foreign bank entry playing a major role, and also some portfolio investment.

Financial Intermediation 2005, in % of GDP

	Domestic credit	Private credit	Stock market	Bonds	TFI
Bulgaria	43.62	44.49	5.12	22.21	71.82
Croatia	73.54	60.80	35.25	55.36	151.40
Romania	19.29	11.50	19.82	9.12	40.44
Turkey	56.55	26.15	44.60	50.77	121.52
Greece	113.65	84.84	67.97	99.48	252.30

Source: IFS, BIS, BSE, World Federation of Exchange, SSE

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