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THE REGULATION OF FOREIGN BANKS IN  
COUNTRIES OTHER THAN THE UNITED STATES

Working Paper No. 233

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## The Regulation of Foreign Banks

### 1.0 Introduction

The subject of this paper is the political economy of the regulation of foreign banks in countries other than the United States. Answers to the following two questions are sought:

- 1) What are the major types of regulations?
- 2) What are the political and economic forces that cause the observed treatment of foreign banks in each country?

The intent is to investigate the nature and determinants of the regulations facing foreign banks. The emphasis is on the regulations, and not on the characteristics of the various countries. The inquiry is important for several reasons. First, the essay's concerns are topical. Second, if, as seems likely, the reduction of barriers to direct investment in service industries becomes the object of international negotiation, the success of the negotiators will depend in part on their understanding of why countries pursue the policies they do. Third, a comprehensive theory of regulation must be grounded in the analysis of the situation throughout the world, and not just that in liberal, developed countries.

The U.S. Treasury Department has just released a study by the Comptroller of the Currency (hereafter referred to as the Comptroller's report or study) of the regulation of foreign banks in countries other than the U.S.<sup>1</sup> The study finds that U.S. banks have a "substantial degree of access to most financial markets abroad of importance to them, both in terms of initial entry and the powers they may exercise once entry has been accomplished." It concludes that American banks "generally receive equitable treatment abroad," though few countries would allow U.S. banks to acquire control of

large indigenous banks. We use the report as the basic source of data on the regulations and, to a lesser degree, for more general information on specific countries.

Our methodology is extremely simple. First, we categorize and incorporate into a scale the regulatory schemes of various countries vis-à-vis foreign-owned banks. Next, we relate the resulting variable to various country-specific characteristics which we hypothesize to have a bearing on the decision of which policy a country will adopt. The techniques used to provide evidence for the existence and operation of the factor include comparisons of means without significance testing, cross-tabulations, and discussions of cases.

The second section reviews some of the relevant literature on banking, relations between the host country and the multinational company, and regulation. The third section develops a typology of ownership and operating restrictions, and a combination of these. The fourth section discusses the determinants of the regulations. The fifth section suggests origins for some of the determinants, and attempts to integrate certain of the considerations. The final section presents conclusions.

## 2.0 Reasons for the Differential Regulation of Foreign Banks

There is virtually no comparative literature on the national regulation of multinational companies (MNCs). Concern has focused either on the international regulation of MNCs (i.e., Codes of Conduct) or on regulation within a single nation (e.g., Calvet [1977] and Lombard [1977]). Robinson's work on entry control systems [1976] and investment incentives [1979], Sachdev's article [1978] on investment policies, and Safarian's examination [1978] of the policies of developed countries towards multinationals are exceptions.

As far as banking is concerned, the situation is similar. There are few books that deal with the banking systems of several nations. Lees and Eng's study [1974] is descriptive without being comparative or analytical, and barely mentions the role of foreign banks. Baker [1978] describes bank regulation in a number of major countries and includes a chapter on deposit insurance schemes in countries other than the U.S. Though his primary interest is the banks' international activities, he does report on the activities and restrictions on foreign banks in the countries he examines (primarily Europe, the Middle East, and Japan). The Financial Times' Economics Advisory Group [1976] has made a study of banking and monetary policy in the European Economic Community (EEC), but analysis is limited to the latter concern. A recent article by Philip [1978] contrasts Anglo-Saxon financial and banking systems with the continental pattern, but unfortunately he discusses only West Germany, France, and Italy in any detail. There are some works on the political economy of international banking (e.g., Aronson [1978]), and a very few national case studies: Kelley (1977) of the UK, Fayerweather (1974) of Canada, Baum (1974) of the Caribbean, and Boyce and Lombard (1976) and Lombard (1977) of Colombia. However, the bulk of the literature on the regulation of foreign banks remains journalistic.

One can generally expect that a country will regulate foreign banks at least as strictly as domestic banks. Similarly, if a country is generally restrictive towards foreign direct investment, it will probably be at least as restrictive in the banking sector as in any other. Banking is considered a key sector in most countries and Kobrin [1978] has found it to be particularly prone to expropriation. Nevertheless, these considerations at best provide only bounds. They do not come to grips with the question of why the constraints on foreign banks relative to domestic banks are tighter in some countries than in others.

We can derive the reasons for differential regulation from two sources. The first is the literature on bargaining with multinational companies (MNCs) and government-MNC relations. The second is the theory of regulation.

The very idea of bargaining with MNCs implies that permitting them entry brings benefits to the host country, but also imposes costs on it. As Streeten [1976] and Morley [1975] discussed the concept, the benefits are technology, jobs, access to markets, etc., and the costs are the excess or monopoly profits that the MNCs earn. In the case of banking, we would argue that excess profits are probably slight except where host-government policies have created market distortions from which foreign banks may benefit. The international banking industry is far from concentrated, and each potential investor country is represented by a number of banks [Tschoegl, 1979]. Competition, actual or potential, should work to undermine monopoly profits. The benefits from foreign entry include trade promotion, access to capital, access for domestic banks to other countries, enhancement of domestic financial markets, and creation of an international financial center. The idea of countries negotiating with foreign firms also introduces the question of relative bargaining strengths and the role of foreign governments.

The literature on host-country--MNC relations is dominated by the question of sovereignty, i.e., the locus of control (e.g., Vernon, 1971). Banking is generally considered a key sector, and a foreign presence may be considered problematic for both macroeconomic and firm-level reasons. One may expect a government to be concerned about the effect of the presence of a foreign bank on monetary policy, exchange rates, and investment patterns. At the firm-level, bankers are often credited with the power of life and death over companies because of their ability to grant or withhold credit. This is especially so in countries without well-developed capital markets and with concentrated banking sectors. Countries may be loath to permit foreigners to exercise this discretion.

The traditional theory of regulation emphasizes the public purposes of regulation, in this case the creation of a banking system and the provision of a safe (default-free) asset for households. Thus the desire to assure the stability of the banking system and depositor safety could be a factor in determining host countries' attitudes towards foreign banks.

Chronologically, the traditional view was followed by another which emphasized the "capture" of the regulators by the regulated. Under this theory, regulation is perverted to protect a cartel, or at least inefficient producers. This leads us to consider the possibility that restrictiveness towards foreign banks may be motivated by the domestic industry, or elements of it, pressing for protection from entry.

Finally, a more recent theory [Posner, 1971] stresses the taxation and subsidization functions of regulation. This suggests that foreign banks may be barred if their entry would threaten the viability of a system of cross-subsidization erected by regulatory authorities.

In Section 4, we discuss the determinants of regulation which these theories suggest. However, we must first develop some classificatory scheme that will permit the grouping of countries in terms of their policies.



### 3.0 What Restrictions?

While it is relatively simple to discover the nominal laws and regulations in each country, determining the real situation is a more complex problem. Actual legislation forbidding a particular practice may be lacking, yet each foreign bank entering a country may have to promise the local central bank or other regulatory authority that it will subscribe to a perhaps unpublicized "gentlemen's agreement" which is fully as restrictive. Even more amorphously, all the foreign banks in a country may know that while some particular activity is not forbidden to them by law or regulation, the requisite prohibition would appear or they would be subjected to sanctions if they were to attempt to engage in it. These restrictions may be important, but are nearly impossible to identify in any systematic way. Conversely, regulations or laws may be promulgated but not fully enforced. This may be the consequence of post-legislation redefinition by the relevant government agencies, the impracticality of the regulations (i.e., difficulty of enforcement in principle), or the administrative weakness of the regulatory authorities [Naim, 1978]. Finally, laws or regulations may be applied equally to foreign and domestic banks, but have a differential impact on the two groups.

The typology of the regulation of foreign banks used in this paper is based primarily on the data in the Comptroller's report. The authors of the report have attempted to overcome the problem of identifying the actual situation by surveying U.S. banks with international operations and U.S. embassy personnel for their assessments.

In the abstract, it is simple to specify the polar categories of the classification. One extreme is a policy of complete prohibition on entry. The other is one of national treatment (complete nondiscrimination between domestic and foreign-owned banks).

Both extremes occur. Many countries prohibit any foreign bank presence, and others permit only representative offices. Absolutely national treatment, however, is particularly rare. On the one hand, even very open countries may retain some limitations. Safarian [1978] noted that the governments of the nine developed countries he examined had a position that could be described as protection of key firms against foreign takeover. As the Comptroller's study indicates, this policy extends to the foreigners' right to acquire major domestic banks. On the other hand, legal lacunae or even government policy may lead to advantages for foreigners. It is therefore more useful to think in terms of approximate, rather than absolute, national treatment.

Between these extremes, classification becomes more difficult. Foreign banks may in effect be permitted to engage in almost all the same activities as do domestic banks, as long as they do not engage in some key activities (such as accepting demand deposits) and do not call themselves banks. Restrictions may also differ for different organizational forms (branch or subsidiary) or depending on the extent of foreign ownership. They may depend on the nationality of the foreign bank, whether it is government or privately owned, or the size of its operations. Finally, when foreign-owned banks or their branches are constrained in some respects relative to domestic banks, the regulatory authorities may release them from other requirements.

In certain cases where the authors of the Comptroller's report felt that the regulatory situation in a country with respect to the form of entry permitted was unclear or ambiguous, we have imposed our own subjective assessment. Where regulations discriminate among foreign banks (e.g., by country of origin), we have based classification on the treatment which would appear to be accorded the majority of the world's largest banks.

In the next two subsections we discuss ownership and operating restrictions separately. The third subsection combines these two dimensions.

### 3.1 Ownership Restrictions

Classification is based on two questions, asked in sequence:

- 1) May foreign-owned banks open a branch?
- 2) May foreign-owned banks own a majority share in a local subsidiary, are they restricted to minority positions, or are any holdings in local subsidiaries barred?

These two questions together provide a six-fold categorization, with the categories arranged in order of restrictiveness. Since branching is usually the preferred form of entry, we consider a country that permits foreign banks to open branches but forbids any ownership of a local subsidiary as less restrictive than one that forbids the former but permits even wholly owned subsidiaries.<sup>2</sup> Countries that currently ban any entry, by either foreign or new domestic banks, are classified by their previous policy since the policy is nondiscriminatory with respect to origin. We do not factor in whether or not representative offices are permitted. Since, for most of the discussion below, we will be collapsing the existing categories even further, the need for extra precision is questionable.

As far as the second question above is concerned, we attempt to focus on the organizational form permitted or required for entry, and not on whether different rules apply to de novo entry than to acquisitions of major indigenously owned institutions. We take as given that almost no countries would permit the latter. This approach, however, involves us in further interpretation of the data, since the Comptroller's report does not always distinguish between the two possibilities. As a final qualification, the classification refers only to the restrictions governing domestic banking

markets as defined by the country. We do not take into account regulations governing offshore banking units which countries may authorize and which are service analogs of manufacturing operations in export trade zones [McCarthy, 1979]. We also do not adjust the classification for those cases where foreign banks may establish financial subsidiaries provided that these do not call themselves banks and do not engage in certain retail banking activities.

Table 1 presents the classification, the number of countries falling into each category, and a weighted classification. This last consists of the proportion of the total gross national product (GNP) of the countries in the sample represented by the countries falling into each category. Clearly, there is a certain clustering towards the extremes.

The figures for the most restrictive category understate its true relative importance. A small number of countries such as Albania, Vietnam, and North Korea, among others, were omitted. These all happen to be highly restrictive towards foreign bank entry. Inclusion of the United States would probably not change the picture. Most states are quite restrictive, though some of the wealthiest are not. The states would thus be distributed over the spectrum of categories.

### 3.2 Operating Restrictions

Operating restrictions provide countries with ways to tailor their regulation of foreign banks beyond the fairly crude limits given by ownership provisions. Operating restrictions take many forms. Table 2 lists some of the ones most frequently encountered. Table 3 presents the classification of the countries into three categories on the basis of a subjective assessment of the severity of the restrictions. In the first category are those countries that have no, or seemingly only minor, restrictions. The

Table 1  
Ownership Restrictions  
(1979)

Branch	Subsidiary	No. of Countries (A)	Proportion (GNP-Weighted) (B)	No. of Countries (C)	Proportion (GNP-Weighted) (D)	Classification (E)
Yes	Maj.	6		4		
		52	32%	52	32%	OPEN
	Min.	5		3		
		13	14%	17	15%	RELA-TIVELY OPEN
		4				
	4	2%				
No	Maj.	3		2		
		7	1%	28	10%	RELA-TIVELY CLOSED
	2					
	21	9%				
No	No.	1		1		
		41	43%	41	43%	CLOSED

NOTE: 1) Numbers in upper right-hand corners in columns A and C are orderings

2) Proportions are based on the number of countries falling in the category multiplied by their GNPs in U.S.\$ billions in 1978 (or nearest year)

SOURCES: Comptroller's Report, 1979.

Table 2

Operating Restrictions

Restrictions On:	No. of Countries
Number of Branches	19
Access to Government Deposits or Business	19
Ability to Staff with Home-Country Nationals	11
Access to Retail Deposits	10
Liquidity, Capitalization, Leverage	8
Access to Central Bank Rediscount	5
Access to Government Export Financing Schemes	5
Access to Non-International Trade-Related Activities	4
Differential Tax Burden	3
Profit Remittances	2
Miscellaneous	8

Table 3

OPERATING RESTRICTIONS

# Of Countries	Proportion (GNP- Weighted)	Classi- fication
76	36%	Essentially Non-Discriminatory
31	29%	Restrictive
31	35%	Prohibitory

middle group consists of the countries that permit foreign banks to operate but impose restrictions that would seem to be significant. The third group consists of those countries that ban foreign-owned banks outright, forbid them any but the most minor roles, or restrict them essentially to activities associated with international trade.

As one can readily see, operating restrictions are a less popular regulatory mechanism (in terms of the number of countries adopting them) than are ownership restrictions. This is probably a function of administrative convenience. Ownership restrictions require little or no surveillance of banks by regulatory authorities. When restrictions are imposed, limitations on deposit-taking and branching are among the most frequently used.

### 3.3 Synthesis

In this subsection we combine the results from the previous two to arrive at an overall classificatory scheme. We treat ownership and operating restrictions as two dimensions of regulatory policies. Figure 1 shows the resulting cross-classification. The divisions are subjective, but there is a rough ordinality to the categories. Thus we map the two dimensions back onto one, while limiting the number of categories.

The simple correlation between a country's numerical rating on the two dimensions of ownership and operating restrictions is 0.582. Cramer's V for Table 4 is 0.407.<sup>3</sup> Thus there seems generally to be a high degree of consistency between a country's policies on the two dimensions. Nevertheless, there are some cases where there is no relationship.

One such situation occurs when a country bars further foreign entry in any form, but permits existing foreign-owned banks the same scope of operation as domestic banks.<sup>4</sup> Mozambique represents an opposite case. There, entry



Figure 1

TYPOLOGY OF REGULATORY REGIMES

OPERATING RESTRICTIONS	1	Essentially Non-Discriminatory		Restrictive	Relatively Open	Open		
	2	Restrictive				Relatively Open		
	3	Prohibitory		Very Restrictive	1	Closed		
	1	Closed	2			Relatively Closed	3	Relatively Open

OWNERSHIP RESTRICTIONS

TABLE 4

CROSS-CLASSIFICATION BY OWNERSHIP AND OPERATING RESTRICTIONS

		TOTAL				
OPERATING RESTRICTIONS	3	7	16	7	46	76
	2	10	11	5	5	31
	1	24	1	5	1	31
	TOTAL	41	28	17	52	138
		1	2	3	4	
OWNERSHIP RESTRICTIONS						

$$\chi^2 = 44.208 \quad (p \leq .001)$$

$$\text{Cramer's } V = 0.407$$

per se is free, but the laws governing commercial banking are so restrictive as to have driven all but one nongovernment bank out of operation.

Table 5 parallels Tables 1 and 3. In the tests below, because of the small number of cases in the second and fourth categories, we frequently combine the first and second, and the fourth and fifth.

Table 5  
Degree of Openness / Restrictiveness

Category	Number of Countries	Proportion (GNP Weighted)
5) Open	46	29%
4) Relative- ly Open	17	16%
3) Restrict- ive	44	19%
2) Very Rest- rictive	7	2%
1) Closed	24	34%

#### 4.0 Determinants of Regulation

The determinants are grouped under ten conceptual headings: control/dirigisme, dependence, the domestic banking industry, depositor safety, relations with other governments, source of funds, trade promotion, reciprocity, enhancement of domestic financial markets, and creation of a financial center.

#### 4.1 Control/Dirigisme

The literature on foreign direct investment is replete with references to the problems that the presence of foreign firms may cause governments which seek to impose some policy. The foreign firms can be expected to react to government policies in a different manner than would local firms, and may have better means for evading restrictions since they span borders and can transfer resources internally [Lessard, 1979]. Their responses may thus weaken, or even negate, the effect of policies; in fact, the policies may even give foreign firms an advantage over wholly domestic firms [Fung, 1978, and Hawkins & Macaluso, 1978].

In the non-Communist countries, governments pursue two different types of policies when they wish to introduce their priorities into the banks' decisions. They either socialize the banking system in whole or in part, or leave it in private hands but promulgate rules which constrain the banks' freedom of action. Regulations often specify the interest rates which depositors can receive or borrowers must pay. The government may require the banks to allocate credit directly. Such credit allocation is a frequent concomitant of interest-rate policies, though it may occur independently of them. We do not have sufficient information on the existence of credit allocation and interest rate ceiling policies to relate these to the degree

of restrictiveness vis-à-vis foreign banks. Instead, we must make do with proxy variables.

We would hypothesize that countries which feel that the banking system is so important to the conduct of the economy that it must be government-owned (i.e., socialized) would be highly restrictive towards foreign banks.<sup>5</sup> Such countries might permit a limited foreign presence because of some of the other considerations discussed below, but would be careful to restrict the foreigners to just those key activities which justify their presence. The government's opposition in these cases is probably based more on the fact that the banks are private than that they are foreign.

Labelling the remaining countries as "not socialized" is too crude since this lumps together countries such as India, where the commercial banking system is some 95 percent government-owned, and others such as the U.K., where all banks are publicly owned. We have therefore further differentiated the countries in this category into two: those in which the government owns a major commercial bank and those in which it does not.<sup>6</sup> In Table 6 we cross-tabulate the resulting variable with our regulatory scale. There is a very strong association between the existence of a socialized banking system and the imposition of restrictions on foreign banks; however, this is essentially due to the fact that this category differentiates those countries that are closed or very restrictive from all the others. If we examine the four cells in the lower right-hand corner, it is clear that countries where the government owns a major commercial bank are more likely to be restrictive than those in which it does not.

Government ownership of commercial banks is an imperfect proxy for the desire to control since these two policies may be quite independent. On the one hand, the ownership may simply have resulted from takeover of a failed

Table 6

GOVERNMENT OWNERSHIP OF THE BANKING  
SYSTEM AND DEGREE OF OPENNESS/RESTRICTIVENESS

		Socialized Banking System	Government Owns Major Commercial Bank	Essentially Private
	1 + 2	26	3	2
Degree of Openness/ Restrictive- ness	3	3	24	17
	4 + 5	4	19	40

$$\chi^2 = 87.510 \quad (p < 0.000)$$

$$\text{Cramer's } V = 0.563$$

bank, or from the growth and diversification of a rural or postal savings bank system. Such banks might function in a manner indistinguishable from that of private banks, and the whole system might be marked by relatively little government direction. Austria is possibly a case in point. On the other hand, all banks might be privately owned but subject to extensive direction. Greece and Japan are illustrative cases. We are confident that a more accurate measure of the desire to control would give results even better than the already strong ones from our proxy variable.

#### 4.2 Dependence

West [1973] distinguishes three perceptions of dependence: 1) the dominating presence of foreigners; 2) commodity composition, concentration, and technical level of developing countries' output and foreign trade compared with those of the developed countries; and 3) participation in the international capitalist system.

A concern with dependence (of the first kind) differs from a concern with control. In the latter case, it is the freedom of action of decision makers external to itself that a government wishes to circumscribe. In the former, it is the role of decision makers external to the nation that is the cause of concern.

We have no measure for dependence. It is difficult to develop an indicator because contrafactual perceptions are often involved: that is, it is believed in the country that if it were not for the restrictions, foreigners would dominate.

That it is difficult to quantify the concept does not mean that it is not important. The very fact that many countries are averse to the acquisition of major domestic banks by foreigners, while perhaps even encouraging



the takeover of smaller, troubled banks, bespeaks a certain reservation. We will illustrate the operation of the factor with reference to two regions (Scandinavia and Latin America) and several countries (Morocco, Nigeria, Saudi Arabia, and Canada).

Until recently, all the Scandinavian countries (Sweden, Norway, Denmark, Finland, and Iceland) were distinctly more restrictive towards foreign-owned banks than were other European countries. Denmark is now more open, as a result of its implementation of a 1973 EEC directive.

If, for the moment, we use the six-way division of ownership restrictions as an interval scale, the average category for the five Scandinavian countries (including pre-1975 Denmark) is 1.4 and the mode is 1 (i.e., no foreign presence except perhaps in the form of representative offices). For the other eight EEC countries plus Switzerland and Austria, the average is 5.5 and the mode is 6 (i.e., no restrictions). The Scandinavian prohibition is long-standing and is probably due to a number of factors. While none of the banking systems are socialized, the government owns a major commercial bank in four of the five countries. In Norway, the government appoints the directors of the private banks. In addition, we suspect--without proof--that one cause of the Scandinavian countries' restrictiveness was a fear of domination by Germany and, for some, by Sweden. In our opinion, and again without proof, the other European countries have solved the problem of what to do about Germany by bank-level "nonaggression" pacts. There is still very little cross-FDI in banking among the countries, and far less than one would expect given the existing physical and cultural proximity.

A second region in which concern for dependence may play a part is Latin America, especially Mexico and the Andean Pact countries. Here the primary concern is with domination by U.S. banks. We discuss the case of the Andean

Pact in Section 4.5 below. The Mexican prohibition on foreign entry stems from the international banking crisis of the 1930s. The policy has been continued because of a fear that U.S. banks would overwhelm the smaller and less sophisticated Mexican banks and the Mexican financial system would become simply a satellite of the U.S. financial system. The first of these concerns may be fading as the Mexican banking system becomes less fragmented and Mexican banks begin to operate abroad.<sup>7</sup>

Several countries where much of the banking system was foreign-owned have used forced divestiture requirements to bring about majority domestic ownership. Three cases in point are Morocco, Nigeria, and Saudi Arabia.

Prior to 1973, most commercial banks in Morocco were foreign-owned. The nationalization policy that began in that year required 50 percent Moroccan participation in all indigenous banks. In the same year, the Nigerian government acquired 40 percent of the shares of the three largest foreign-owned banks in that country. At the time, ten of the twelve commercial banks were foreign-owned. In 1977, the government promulgated a decree requiring 60 percent Nigerian ownership in all banks. While the government itself generally acquired all the divested shares, the policy was put forward as one of nationalization rather than socialization. In Saudi Arabia the government is permitting little new entry, and since 1975 it has required foreign bank subsidiaries to sell at least 60 percent of their shares to Saudi citizens. Before the inception of "Saudi-ization," the proportion of Saudi-owned banks to foreign ones was, as in Nigeria, two to ten. In each of these cases, one might suspect that the countries have been able to pursue these policies because of an advantageous bargaining position based on natural resource wealth.

The last case we will discuss is that of Canada. While U.S. foreign direct investment has been a major political issue for some time [Calvet, 1977], the role of concern with dependence in the banking sector was most clearly revealed in the Mercantile Bank affair [Fayerweather, 1974].

First National City Bank (a U.S. bank now known as Citibank) acquired the Mercantile Bank from its Dutch owners in 1963. Mercantile was the smallest of the eight chartered banks then in Canada, and the only one to be foreign-owned. At the time, and still currently, foreign banks are not permitted to open branches or agencies, and establishment of a bank subsidiary requires chartering by an act of Parliament. It was clear that Parliament would not charter any foreign-owned bank, and Citibank's acquisition was regarded by many as the exploitation of a loophole in Canadian banking law. The acquisition gave rise to great debate and resulted in the inclusion in the 1967 Bank Act of a provision prohibiting any foreign ownership of Canadian banks in excess of 25 percent, with any one foreign shareholder being restricted to 10 percent. It is clear that much of the opposition was on nationalistic grounds and involved the fear that other foreign, and particularly U.S., banks would acquire Canadian banks. The Canadian Bank Association took no position on the issue, and the major Canadian banks individually did not oppose the acquisition.

A concern with dependence of the second kind--the commodity composition, concentration, and technical level of the country's output and trade--might lead to some freeing of entry. Countries may look to foreign banks to facilitate trade, provide access to international capital markets, and improve local capabilities (see below). It might also lead them to encourage the geographical expansion of one or more of their own banks to act as national

"flagships." This in turn could lead to a concern with reciprocity which would also work in the direction of encouraging some reduction in restrictiveness.

A concern with dependence of the third kind, inclusion in the international capitalist system, must work against the government opening its domestic market to foreign banks. We have developed an indicator of anti-capitalist orientation based on type of political system. We distinguish two categories of countries: those with one-party Socialist or Communist political systems on the one hand, and all others on the other. We would argue that the former are the countries most likely to have an ideological antipathy to the international capitalist system. Table 7 presents the results of cross-tabulating this variable with our usual regulatory scale. We find the expected relationships; that is, countries with one-party Socialist or Communist regimes tend to be closed or very restrictive, and countries without such systems tend to be restrictive or relatively open.

We would also expect an anticapitalist orientation to work against the country permitting its own banks to open offices abroad, but to a lesser degree. In Table 8 we take the countries with GNPs greater than or equal to US \$5 billion, and categorize them separately by their type of economy and whether or not they have one-party Socialist or Communist regimes. We then calculate the average number of branches or subsidiaries in New York or London for the countries which fall in each of these categories, relative to their GNPs. The countries in rows 1 and 5 do have branches in the two centers, but the averages are notably smaller than the averages for the other categories. In part, this is because their banking systems are so highly centralized that they have relatively few banks. Even so, the differences in means are quite striking.

Table 7

DEGREE OF OPENNESS/RESTRICTIVENESS  
AND SOCIALIST OR COMMUNIST ONE-PARTY SYSTEM

	Socialist or Communist One- Party System	Other
5	3	43
4	0	17
3	3	41
1 + 2	12	19

$\chi^2 = 50.615 (p \leq 0.001)$

Cramer's V = 0.606

Table 8

BRANCHES OR SUBSIDIARIES IN NEW YORK OR LONDON PER  
US \$1 BIL. OF GNP FOR COUNTRIES WITH GNPs OF US \$5 BIL.  
OR MORE, BY ECONOMIC SYSTEM AND POLITICAL SYSTEM

		Mean	Standard Deviation	Range	No. of Countries
Economic System	Socialist	0.04	0.04	0-0.13	11
	Capitalist- Socialist	0.14	0.17	0-0.59	12
	Capitalist- Statist	0.19	0.22	0-0.86	17
	Capitalist	0.21	0.21	0-0.74	23
Political System	One-Party Socialist or Communist	0.05	0.06	0-0.21	13
	Other	0.19	0.21	0-0.86	50

#### 4.3 The Domestic Banking Industry

A government may choose to protect the domestic banking system when it fears the competition foreign entry may bring. This leads to the questions of why a government should concern itself with the consequences of competition and why the domestic industry might be vulnerable. The two questions are interrelated. Some of the causes of vulnerability define the consequences which could follow entry. There are a number of nonexclusive situations that might lead to protection of the local banking industry--for example, when it is in its infancy, "constrained," inefficient, "overbanked," or cartelized.

Infancy is a question not so much of age as of a perceived ability to compete. If the local banks are small and technically unsophisticated, the government may, with or without their urging, decide to protect them from entry. As discussed earlier, it may also use restrictions to help create a domestically owned industry.

Our indicator of the ability of the domestic banking sector to face foreign competition is the number of banks from that country which rank among the world's top 300 [The Banker, June 1979]. We limit the sample to those non-Communist countries with GNPs of \$5 billion or more, i.e., roughly those countries which conceivably might have banks of the requisite size. We then divide the resulting variable into two categories: one or no world-class banks, and two or more such banks. The reason for defining the categories in this manner is that the presence of only one very large bank may represent a situation of effective monopoly, with the bank being unused to the presence of rivals. We cross-tabulate the variable against the regulatory scale. As Table 9 shows, countries with two or more world-class banks tend to be less restrictive than those with fewer.

Table 9

NUMBER OF BANKS IN THE WORLD'S TOP 300 BANKS  
AND DEGREE OF OPENNESS/RESTRICTIVENESS

No. of Banks

	n 1	n 2
Degree of Openness/Restrictiveness 4 + 5	8	12
3	14	8
1 + 2	9	2

$$\chi^2 = 13.828 \quad (p \leq 0.001)$$

$$\text{Cramer's } V = 0.511$$



A government may also discriminate against foreign banks if its policies constrain the domestic industry. Governments frequently impose special requirements on domestic banks that limit their ability to compete with foreign banks. Credit controls, allocation schemes, or a requirement that banks grant preferential loans to local governments or nationalized industries are not uncommon. In effect, the government is involving the banking system in cross-subsidization, taxing some bank customers in order to provide others with services below cost. If the host government excuses foreign banks from the same requirements (perhaps on de minimis grounds), it may feel compelled to impose other constraints to approximate an overall competitive parity, or more probably, to put foreign banks at a relative disadvantage.

If the beneficiaries of the cross-subsidization policy are retail customers, especially rural ones, and the "tax" is borne by corporate customers, the implications for foreign entry are clear. Foreign banks must be excluded or restricted since they can be expected to "cream-skim." That is, they will compete in the corporate market by offering the same services as domestic banks but at a lower price. They are very unlikely to operate rural or even urban branch networks and thus at worst can keep the remaining "tax revenue" for themselves, or at best compete it away. Given sufficient foreign entry, the whole structure of subsidies and taxes would collapse, resulting either in major losses for the domestic banks or, if it is permitted, the wholesale abandonment of rural branches. The effect of these considerations can be seen in the cases of India and Australia.

In the 1950s and 1960s, the Indian government wished to encourage the extension of banking to the rural areas where the bulk of the populace lives. The private banks, which were associated with major industrial groups owned by particular families, were relatively obdurate. The government-owned State

Bank of India, the largest in the country, complied with the policy; however, because it was in competition with the private banks, it could do so only to a limited degree. In 1969, therefore, the government took over the fourteen largest banks, bringing almost the entire banking system under its direct control. It also banned further foreign entry and restricted the already present foreign banks to their existing number of branches. Following the 1969 socialization, there was a major increase in rural branching by all the now government-owned banks [Chitre, 1978]. In 1980, the Indian government socialized almost all the remaining private domestic banks.

In Australia, one of the major reasons put forward by the commercial banks for their continuing monopoly of full banking licenses and, in particular, of foreign exchange business is the fact that they provide an extensive network of retail banking services [McGuinness, 1979, p. 67]. Whether or not their argument is valid, one can infer from the fact that the foreign banks' financial subsidiaries are very interested in entering this market that the foreign exchange business is quite profitable.

The presence in the banking system of government-owned banks can lead to restrictions for reasons other than that banks pursuing social goals are forced to compete with others pursuing private ones. An additional reason for the association between government ownership of major commercial banks and restrictiveness is that these banks may be particularly inefficient. Crain and Zardkoohi [1980], among others, have shown that government-owned firms use more labor than do comparable private ones. Chitre [1978] found a similar tendency in the behavior of Indian banks after socialization, as well as a tendency for operating expenses per employee and per branch to increase more rapidly than the rate of inflation. Short [1979] found that

government ownership was negatively related to profitability for banks from Canada, Western Europe, and Japan.

If these findings are generalizable, then for many countries, permitting entry would result either in a crisis for government-owned banks or in the accrual of excess profits to foreigners. Protection, then, is a logical outcome.

A number of countries have barred new foreign bank entry on the grounds that the domestic system is in danger of being "overbanked." Basically, "overbanking" means that actual or incipient overcapacity in the industry is such that intensified competition would drive some institutions out of the market.

While banks and regulatory authorities frequently refer to the problem as a rationale for protecting a cartelized situation, there are more legitimate reasons for concern. First, failure of one bank as a result of competition could, in the absence of deposit insurance, result in a run on other banks, hence disrupting the banking system and perhaps even causing the failure of otherwise sound banks. Second, as just discussed, which banks are likely to be driven out may be an important consideration. Third, in a world of imperfect information, potential entrants may misread the market as being profitable because of their unfamiliarity with it. Their entry could then bring about the consequences just mentioned without effecting any offsetting benefits such as a more efficient domestic banking system. Hence, the regulatory authorities, who are charged with a concern for external effects and who are the only party with cost and profit information on all the banks, have a duty to intervene.

It is interesting that in several cases in the sample, closure to entry--foreign and perhaps also domestic--followed a recent increase in the number

of banks established.<sup>8</sup> In the United Arab Emirates, a large number of foreign banks entered after the 1973 oil price increase. The monetary authorities adopted a highly restrictive entry policy affecting both domestic and foreign banks after a banking crisis in 1977, during which two banks (one local and one foreign) became insolvent.<sup>9</sup>

If the domestic industry is cartelized, some domestic banks may have survived despite a lack of efficiency relative to banks from more competitive countries. Cartelization may also give others excess profits. Both groups of banks would then have reason to press for protection from entry. The government may still tolerate the cartelization, even where it has not actually organized it, as a way of assuring depositor safety. It might view the costs of this policy as the price to consumers of the insurance they receive.

We have no comprehensive information on the existence of cartels. Concentration, for which data is also hard to find, only indicates the potential for cartelization, but does not prove its existence, though Short [1979] did find a positive relation between concentration and profit rates in Canada, Western Europe, and Japan. However, the effect was small, requiring large changes in concentration to change profit rates by one percentage point.

Cartels may exist without substantial concentration if the government tacitly accepts or actively sponsors them. In fact, cartelization may coexist with open entry if government requirements or a concern for "good corporate citizenship" induces entrants to join the cartel. In Hong Kong, for instance, foreign banks are members of the committee that determines interest rates, though recently there have been complaints that the cartel's rates discriminate against recent entrants [Goodstadt, 1979]. The government fostered the creation of the cartel in 1964, after interest-rate competition caused the failure of several banks. As the examples of Hong Kong and

Australia indicate, while cartelization may on occasion be associated with restrictiveness, it remains difficult to disentangle the cases where the operative factor is government concern for the stability of the banking system and depositor safety from those cases in which the regulators have been captured by the domestic industry.

The role of cartelization, (or, more generally, anticompetitive practices) in causing official restrictiveness is further obscured by the possibility that given the former, the latter is less necessary. In West Germany, for instance, banks may own the shares of other companies, and deal in them. They may also vote shares which as brokers they have bought for customers and which have been entrusted to them for safekeeping. As a result, bank influence over corporate policies may be quite great. Close bank-company ties make it difficult for foreign banks to make customers of major domestic corporations. Thus, while Germany is quite open as far as regulations are concerned, in actual practice it is less so.

#### 4.4 Depositor Safety

The efficiency of the banking system as a payments system and as a source of a relatively riskless asset for households requires that retail banks be safe, i.e., have a very low probability of default. In the absence of some assurance that deposits are safe, prudence forces depositors to maintain accounts in several banks, presumably after having investigated each. This imposes extensive transactions costs on banks and depositors alike, and can be expected to reduce the utilization and utility of the banking system.

Governments have devised various ways of achieving the desired level of safety. The most common seem to be: (1) for the government to own the major retail banks; (2) for the government to so regulate the degree of competition,

the riskiness of banks' portfolios, or the degree of leverage, as to render the probability of depositor losses effectively zero; and (3) for it to insure deposits implicitly, either by standing ready itself to rescue any failing bank or by compelling other domestic banks to effect the rescue. One fairly rare alternative is explicit deposit insurance. Other methods usually accompany this strategy as well.

No matter which course the government pursues, the concern for depositor safety will influence its attitude towards foreign banks. First, the government will be concerned with the effect of competition on the viability of existing domestic banks, since if any fail de facto they will become a charge on the public. We have already dealt with this issue in the preceding section. Second, it will have to face the problem of the safety of deposits in foreign banks. Many countries solve this problem by limiting foreign bank access to such deposits, or by imposing more restrictive prudential requirements. Table 2 above gives the various types of regulations and the number of countries utilizing each one. Some countries may impose several different types of measures.

Branches pose a particular problem for regulatory authorities since they are more or less integral parts of the parent: if the parent fails, the branch fails. It is unclear, and probably depends greatly on local law, whether local depositors would have first call on the branches' assets, or whether they would join all the other claimants against the parent and share pro rata in any recovery on the basis of the bank's total assets. While failure depends on the condition of the parent, its books are beyond the reach of local authorities.

These problems do not apply in the case of subsidiaries. The subsidiary does not fail simply because its parent has. Furthermore, the regulations

governing a subsidiary are quite clear: local depositors have first call on its assets, and regulatory authorities can examine its books and operations. Of course, unlike a branch, a subsidiary may fail without the parent failing, but this is still somewhat under the authorities' control.

In Table 10 below, we examine the relationship between restrictions on deposit taking and the forms of entry permitted foreign banks. We look only at those countries where entry in some form is permitted, but where if branches are authorized, majority foreign-owned subsidiaries are prohibited, and vice-versa.

As the log odds indicate, there does seem to be an association between the two dimensions of the table, though it is not statistically significant.<sup>10</sup> Of the three countries in the lower right-hand corner, two restrict foreign banks to transactions related to international trade. The one country in the lower left cell does not impose restrictions on deposit taking per se. It does, however, require higher capital adequacy ratios relative to deposits for foreign banks than for domestic ones, though the former are exempt from certain other prudential regulations.

The countries having governmental insurance of deposits (India, the Philippines, and Japan) are too few to permit generalizations about the relationship between the existence of such insurance and the regulation of foreign banks. In the first of these countries, the existing branches of foreign banks are excluded from coverage, and in the other two the situation is unclear [Baker, 1978]. In West Germany, insurance is provided by an association of banks, and foreign banks may take part. The U.K. and Canada are contemplating insurance schemes.

Table 10

FORM OF ENTRY PERMITTED

		Deposit Restrictions	
		No	Yes
Form of Entry	Subsidiaries But Not Branches	7	1
	Branches But Not Subsidiaries	1	3

$\chi^2 = 3.045$  ( $p \leq 0.11$ )



#### 4.5 Relations with Other Governments

As Krasner [1976] points out with respect to international trade, openness (defined as a regime in which tariffs are falling, trade proportions are rising, and regional trading patterns are becoming less extreme) is more likely to occur during periods when a hegemonic state is in its ascendancy. Gilpin [1971] argues that "politics determines the framework of economic activity and channels it in directions which tend to serve the political objectives of dominant groups and organizations" and "the multinational corporation exists because it is consistent with the political interest of the U.S." The key point is that nations do not formulate their policies in an international vacuum. Openness to foreign banks may be influenced by political, military, or economic alliances between states. We will examine two illustrative cases: the EEC and the Andean Pact. In the first case, each member country is required to be open to entry by institutions from all other members. In the second, the policy has been one of exclusion or restriction of non-Pact member countries.

The EEC has a long-range goal of gradual harmonization of member countries' banking regulations and full mutual freedom of banking activities. While little progress has been made towards the first goal, the second has been achieved, at least nominally. We would classify all the members as open, at least towards each other. Following Denmark's entry into the community, the EEC amended its bank regulations to allow foreign banks to open branches, irrespective of whether or not they were from member states. Ireland, by contrast, opened entry in branch form only to banks from countries within the EEC. Banks from other countries are restricted to subsidiaries, and are subject to operating restrictions.

Currently, Spain, Greece, and Portugal are negotiating entry into the EEC. All are restrictive but are currently amending or are expected to amend their regulations to bring them into conformity with the principle of open entry.

In 1978, the Spanish government authorized new foreign bank operations for the first time in forty years. All in all, twenty-one banks received authorization to open branches over the subsequent two years. Of these, six are from the U.S., one is from Japan, and the remaining fourteen are from the EEC. Operating restrictions are still extensive, but this may change as the Spanish banks adjust to the competition.

Following its revolution in 1974, Portugal socialized the banking system and barred further foreign entry, though the three existing foreign banks were permitted to continue operating. In December 1979, a coalition of center-right parties won the elections and formed the government, which plans to reauthorize the establishment of private banks. Foreign banks are being permitted to open representative offices, and may be allowed to establish investment companies [Caplan, 1978]. Part of the motivation for these policies is harmonization with EEC practice [World Business Weekly, May 13, 1980, p. 38].

In Greece, the banking system is highly concentrated, very heavily regulated, and to a great degree socialized de facto. Increasingly aware of the need to move closer to European systems as Greece's accession to the EEC approaches, the government has established high-level working parties to study the financial system and to make recommendations for improvements [Pryce, 1978].

The Andean Pact (Cartagena Agreement) of 1969 is an attempt to establish a regional common market among its member nations (Bolivia; Colombia; Ecuador;

Peru; Venezuela; and, originally, Chile). The Andean Foreign Investment Code, an important part of the pact, urges common adherence to strict rules which severely limit foreign ownership in key sectors, including banking. As a result, two of the current five members are virtually closed to foreign banks, and the others have imposed a variety of operating and ownership restrictions. Even so, the countries have not followed entirely consistent policies.

Venezuela, the last to join the pact, is the most restrictive. It also has the largest market and is the richest of the five. Bolivia is the most open, and the poorest. The other three fall between these extremes both in wealth and degree of restrictiveness. Chile, under Allende, was very restrictive. It socialized the entire banking system and expelled all but one foreign bank (Banco do Brasil). Following the overthrow of Allende, the new government withdrew from the pact and now encourages foreign bank entry with a view to making Chile a regional financial center.

These two regional cases provide an interesting contrast. Membership in the EEC is attractive enough that various countries are willing to give up some measure of control and protection of their banking systems as part of the price of entry. The Andean Pact, on the other hand, is unable to enforce an equivalent (though opposite) subordination of national policies.

#### 4.6 Source of Funds

Developing countries may welcome foreign banks because of the role they can play in bringing in capital. While the amounts brought in directly may be quite limited, the country may believe the banks to be catalysts for its borrowing in international markets, or for other private flows. The paragraph below is from the Bank of Thailand's 1977 Economic Report. It refers to the bank's decision to permit the establishment of the European Asian Bank, the first approval in ten years.

The establishment of a branch of a German commercial bank in Thailand might bring benefits to the Thai economy, and encouraged [sic] investors from the EEC to give increased interests [sic] to Thailand. In permitting the European Asian Bank to open a branch in Thailand, important conditions were attached, for instance, the Bank must bring in capital from its head office and/or from the other overseas branches of the bank not less than B[ah]t 100 million within a period of two years, and on the opening day the Bank must have brought in at least B 50 million to be maintained as assets as stipulated.

If a country has access to world capital markets, it can afford to be more restrictive towards foreign banks than if it does not. Lees and Eng [1979] used various economic criteria to group some fifty-one developing countries into four categories in terms of their increasing ability to tap various sources of international funds. In Table 11 we compress the four access and the five regulatory categories into two each. As the log odds show, there is a statistically significant negative relationship between the two dimensions. In the sample, LDCs with greater access to international capital markets are freer to restrict foreign banks than are those with less.

#### 4.7 Trade Promotion

It has often been contended [e.g., Grubel, 1979], and it now appears that there is evidence that banks follow trade [Terrell, 1979; and Tschoegl, 1979]. Banks can also facilitate trade by acting as conduits for market information, and through their financing and operational activities (letters of credit, bankers' acceptances, money movement, etc.). Countries concerned with expanding exports may therefore welcome foreign banks, at least as long as they limit their activities (or are restricted) to international business. The most striking examples of the operation of this factor involve three Communist countries: The People's Republic of China, Rumania, and Hungary.

When the Communists took over China in 1949, they permitted four banks to maintain one branch each in Shanghai.<sup>11</sup> These branches continued to

Table 11

LDC ACCESS TO WORLD CAPITAL MARKETS  
AND DEGREE OF OPENNESS/RESTRICTIVENESS

		Access	
		Low	High
Degree of Openness/ Restrictiveness	1-3	9	20
	4-5	13	6

a = -1.572 (p ≤ 0.001)

operate even during the Cultural Revolution. Very recently, the government has allowed several additional banks to open representative offices.

Rumania is the only other Communist country which permits foreign-owned banks to open branches. Only one U.S. bank has taken advantage of this opportunity, and it is restricted to hard currency transactions for the sole purpose of facilitating foreign trade.

Hungary has just authorized the establishment there of a majority foreign-owned joint venture. The Hungarian partner, the National Bank of Hungary, has the largest shareholding (34 percent). The foreign participation is split equally among six banks, two from Japan and four from various European countries.<sup>12</sup> The bank will concentrate primarily on trade-related activities.

More generally, we have developed a variable for the importance of trade, particularly imports, to the national economy. The variable categorizes the ratio of imports to GNP. The dividing points were chosen to yield three categories with very roughly similar numbers of countries in each. While neither the chi-square statistic nor the degree of association in Table 12 is impressive, the direction of the relationship is as hypothesized.

#### 4.8 Reciprocity

A country may open its market to foreign banks because it wishes to gain access to foreign markets for its own banks. A number of countries require such reciprocity either explicitly in their laws or implicitly in their approval practices. Some countries, particularly those that wish to be the home for an international financial center, do not insist on reciprocity at all (e.g., the U.K.). For many, the whole question is irrelevant since they have no domestic banks willing or able to expand abroad. For those concerned

TABLE 12

RATIO OF IMPORTS TO GNP AND DEGREE  
OF OPENNESS/RESTRICTIVENESS

		R ≤ .2	.2 ≤ R < .4	R > .4
Degree of Openness/ Restrictive- ness	5	8	16	20
	4	3	10	4
	3	12	19	15
	1 + 2	13	13	4

$$\chi^2 = 18.932 \quad (p \leq 0.005)$$

$$\text{Cramer's } V = 0.273$$

with the issue, the definition of reciprocity they adopt cannot be independent of their domestic policies towards foreign banks.

The first, and potentially the most restrictive, definition is similar to a "Most Favored Nation" clause in trade agreements. Each country merely agrees, often implicitly, not to favor banks from one country over those from any other. Even this basic principle is occasionally violated.<sup>13</sup>

The second is a "tit-for-tat" approach. Country A permits country B's banks entry if its own may establish themselves in country B. Some countries insist on some form of numerical parity, i.e., a branch-for-branch rule. This provides them with a mechanism for restricting entry, as well as gaining it. Brazil, for instance, argues that since U.S. banks have some fifty-six branches there, and its banks have only ten in the U.S., it is actually more than accommodating, even though it has permitted almost no new entry since 1964. Interestingly enough, in 1980 Brazil and Venezuela, by special agreement, each permitted one bank from the other country to open a branch.<sup>14</sup>

The third definition is that of "national treatment," i.e., the absence of discrimination in law or practice between foreign and domestic banks. While a "Most Favored Nation" approach is consistent with any domestic policy towards foreign-owned banks, a demand for "national treatment" requires a similar domestic policy.

Finally, the fourth definition is that of "home country powers." This is the doctrine that Country A's banks should have the same powers in Country B that B's have in A. Such an approach is really only open to countries whose domestic banking sectors are relatively unregulated. They can then justify less-than-national treatment of foreign banks and entry restrictions, since few countries would reduce their domestic regulatory practices to this lowest common denominator. Switzerland, to the best of our knowledge, is the



only country that has adopted this approach. Its major commercial banks have few branches or subsidiaries outside of major world financial centers and are not concerned with expanding their access, but rather with limiting competition at home.

We can get some indication of the role of reciprocity by calculating, for each category of our regulatory typology, the mean of the number of banks from a country with a direct presence in London or New York, relative to its GNP. Again, we consider only those countries with GNPs of \$5 billion or more to eliminate those for whom the question is irrelevant. As Table 13 shows, there is a clear association between a country's openness to foreign banks and its representation in the two financial centers.

A concern with reciprocity may drive a wedge between those domestic banks that can take advantage of the opening of foreign markets and are secure in their domestic position, and those that see only the increased competition. A country's position on the issue of reciprocity will then depend in part on the political strength of the two groups. One possibly important factor is into which group the government-owned banks (if any) fall. Unfortunately, we have no data that would enable us to pursue this further.

#### 4.9 Enhancement of Domestic Financial Markets

A country may permit entry by foreign banks to increase domestic competition and to introduce new capabilities to the local financial markets. Domestic banks may even welcome the entry, or at least not oppose it, for two reasons. First, there is the question, just discussed, of reciprocal access to other markets. Second, having ready access to a large number of sellers who offer somewhat different products reduces search costs for buyers. Foreign banks are particularly likely to offer different products, since their

Table 13

BRANCHES OR SUBSIDIARIES IN NEW YORK OR LONDON PER  
US \$1 BIL. OF GNP FOR COUNTRIES WITH GNPs OF US \$5 BIL.  
OR MORE, BY DEGREE OF OPENNESS/RESTRICTIVENESS

	Mean	Standard Deviation	Range	No. of Countries
1 + 2	0.06	0.09	0-0.35	20
3	0.19	0.23	0-0.74	12
4	0.24	0.21	0-0.59	7
5	0.20	0.22	0-0.86	23

Degree of Openness/  
Restrictiveness

knowledge, methods, and policies will not be the same as those of domestic banks. Search costs are analogous to a tax, and reducing them is equal to an outward shift of the demand curve facing the sellers, in this case the banks [Stuart, 1975]. Hence, the following statement: "While foreign banks may be more competition, they bring more business for everyone."<sup>15</sup> Because of the positive externalities generated, one could even argue that regulators should offer foreigners inducements to enter. If necessary, these could include subsidies and freedom from some regulations imposed on domestic banks.

Spain provides an illustrative case of the role of the desire to enhance the domestic financial sector. Following the death of General Franco, and especially since the elections of June 1977, the Spanish government has moved to modernize the economy, particularly the banking and financial sectors [Muns, 1978]. It has freed certain interest rates and reduced the required ratio of investment in public and privileged activities. Savings banks are permitted to engage in the same activities as commercial banks. In addition, as discussed earlier, the government has started to authorize foreign bank entry to increase the competitiveness and efficiency of the local banking system. To ease the transition, foreign entry is being phased in gradually, and is surrounded with restrictions. As far as the government is concerned, there is clearly no need to induce the desired amount of entry. Moreover, the government seems committed to further liberalization, in spite of domestic pressures to the contrary.

#### 4.10 Creation of a Financial Center

A country may wish to establish one of its cities as an international financial center. The gains would include tax revenues, balance-of-payments effects from the banks' earnings, employment, and reduced transactions costs,

primarily for corporate users of financial services. Johnson [1976] estimated the employment and income effects for Panama but found them to be slight. McCarthy [1979] distinguishes two types of centers--"paper" and "functional." The former provide locations of record but no actual banking takes place in them. In functional centers, banks make loans and take deposits, though these may appear on the books of a branch in a paper center. McCarthy finds that the benefits to the host of the first type are limited to fees and the sums involved are minor. Functional centers are more advantageous to the sponsor, but the net effect is still limited because of the costs of providing the necessary infrastructure.

Nevertheless, the benefits are attractive to countries with limited alternatives. Of the sixteen offshore centers we can identify, ten are island-states and all the others are small, developing countries, except for Luxembourg which is simply small.<sup>16</sup>

The enticement of foreign banks would involve the country in competition with other countries in the areas of freedom from regulation [Giddy & Allen, 1979] and minimization of fees and taxes imposed. This does not necessarily mean that the country must change its policies towards its domestic market.

Several countries have completely separated the international and domestic markets by authorizing foreign banks to establish Offshore Banking Units. These branches generally are permitted little or no contact with the domestic market, but are given relatively wide latitude in their international activities. Of the four countries that authorize OBUs, none permits foreign banks to open branches or to have majority-owned subsidiaries to serve the local market.<sup>17</sup> The other eight offshore centers discussed by McCarthy and for which we have data from the Comptroller's report we would classify as being relatively open or open. Three are currently closed to all new entry because

the authorities feel there are now enough banks. Even these, however, were formerly open, and there do not seem to be any operating restrictions.

## 5.0 Interactions

In this section we discuss primarily the interaction between the countries' political and economic systems, their governments' desire for control (as proxied by ownership of the banking system), and the regulation of foreign banks. In Figure 2, we diagram the degree of association between these variables. The numbers by the arrows are the values for Cramer's V from the relevant cross-tabulations. Those marked with an asterisk are from Tables 6, 14, and 15. The others are from tables not presented in the paper.

First, we will discuss the relationships in the figure. Then we will consider some of the factors that we have discussed earlier.

A country's philosophy about the role of the state has an effect on its desire to control banking. We would argue that one of the operative factors is the nature of the political system and its tolerance for pluralism. In Table 14, we cross-classify countries by their political system and by the degree of government ownership of the banking system.<sup>18</sup> As the table indicates, there is a statistically significant relationship between the two dimensions. There are only two countries (Portugal and Nepal) with a completely socialized banking system and a multiparty political system. There are many countries which have more restrictive political systems but perhaps extensive private sectors. Finally, there are two countries (Burundi and Zambia) with one-party socialist or communist systems, but which permit banking to remain essentially in private hands.

Next, we cross-classify countries by their economic system and the degree of government ownership. Following Gastil [1978, pp. 43-51], we distinguish four types of economic systems: capitalist, capitalist-socialist, capitalist-statist, and socialist.<sup>19</sup> Our hypothesis is that as we go from capitalist to socialist, governments will be more concerned with detailed direction of

Figure 2

Interactions

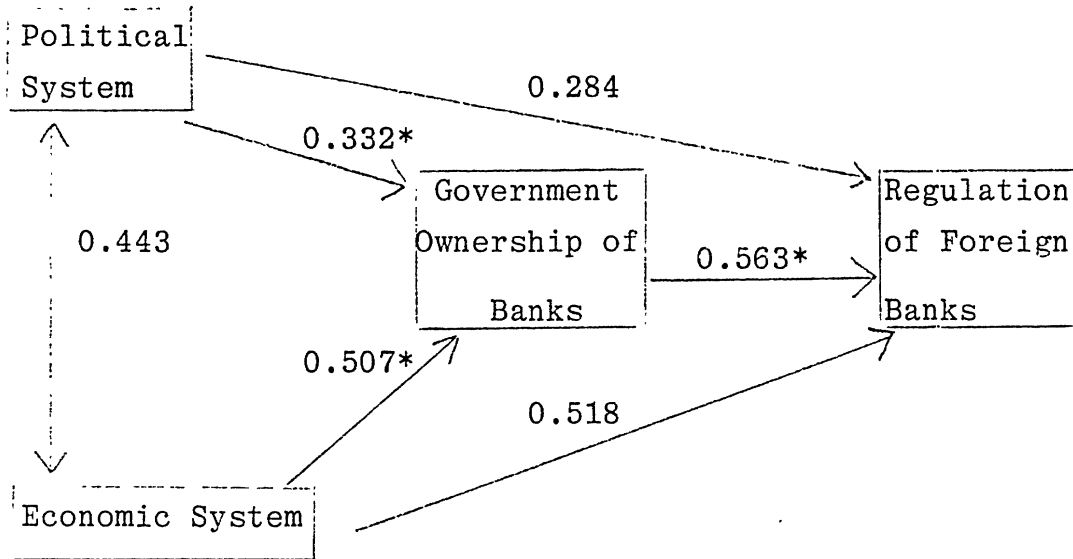


Table 14

GOVERNMENT OWNERSHIP OF THE BANKING SYSTEM  
AND POLITICAL SYSTEM TYPE

		Government Ownership		
		Socialized Banking System	Govern- ment Owns Major Commercial Bank	Essent- ially Private
Political System	Multi- Party	2	21	30
	Other	23	21	23
	One- Party Socialist or Communist	10	3	2

$$\chi^2 = 29.684 \quad (p < 0.000)$$

$$\text{Cramer's } V = 0.332$$



the economy, and thus with any lack of control that a private or foreign bank presence might bring. The results in Table 15 are consistent with this view.

A country's political and economic systems are related, though not necessarily very strongly. On the one hand, of the twenty-seven countries that have socialist or communist one-party systems, or socialist economies, eighteen fall into both categories. On the other hand, capitalist economic systems are consistent with a variety of political systems.

The effect of a country's political system does not seem very strong, at least relative to that of the economic system. This is not quite correct, since as we have seen in Table 7, one-party socialism or communism is strongly related to closure to foreign banks. For countries with other types of political systems, though, it is the view of the role of the government as revealed in the economic system that is important.

It is these basic orientations that determine if some of the other considerations discussed earlier come into play. If a country bars all private banks, it need not concern itself with dependence, the ability of its banks to compete, the effect of entry on the domestic banking system, depositor safety, or the enhancement of domestic financial markets. Only when a country is basically willing to allow private banks to operate does it have to face the question of extending this right to foreign-owned institutions. We can therefore think of the cost-benefit calculus as being a second step, conditional on the country's basic orientation. Those countries that wish to have socialized systems may nevertheless permit some entry because of the role of foreign banks in facilitating trade. Those that permit the existence of an extensive private banking sector may, however, be very cognizant of the costs of foreign entry.

Table 15

GOVERNMENT OWNERSHIP OF THE BANKING SYSTEM  
AND ECONOMIC SYSTEM

		Government Ownership		
		Socialist Banking System	Government Owns Major Commercial Bank	Essentially Private
Economic System	Capitalist	1	24	34
	Capitalist- Socialist	10	7	13
	Capitalist- Statist	6	14	9
	Socialist	18	1	0

$$\chi^2 = 70.496 \quad (p < 0.000)$$

Cramer's V = 0.507

Dependence emerges as one of the most important of these "second-stage" cost considerations. A fear of the dominating presence of foreigners and the perceived ability of domestic banks to compete are inversely related. Even so, objective measures and the perceptions of the government or the populace at large may be at variance with each other. In fact, the real situation may be irrelevant. Given the importance which governments and people attach to the banking sector, close proximity to particular foreigners may lead to policies of closure despite the country's basic political-economic orientation or the capabilities of its own banks.

## 6.0. Summary and Conclusion

This essay is an initial effort in a cross-national study of the regulation of international business and, more specifically, the regulation of foreign banks. First, we developed an ordinal scale of the relative openness or restrictiveness of a country's policies vis-à-vis foreign banks. We then related this scale to ten factors drawn from theories of bargaining between MNCs and governments, and theories of regulation. The intent was not to test the theories either individually or against each other, but rather to use them as sources of insight or perspective.

One impression that emerges from the study is that the key factor in determining a country's position on foreign bank entry and operations is what it perceives to be the costs of such activities, rather than the benefits. Benefits seem to have only a slight effect, since it is possible to gain many of these while still being highly restrictive.

Some countries, primarily those with socialized banking systems, object to foreign banks because they are, or would act like, private institutions. A number of countries with essentially private banking systems oppose foreign banks simply because they are foreign, and they fear that their banking systems will become dominated by foreign institutions.

In the case where the government is concerned with retaining control, the underlying cause is political--the country's view of the proper role of the state. In the case of dependence, the causes appear to derive from historical patterns of investment, as well as the political and economic relations between states.

In addition to these basic sources of attitudes towards foreign banks, the nature of the domestic industry seems to have an effect. The regulatory authorities are responsible for the stability of the banking system and

depositor safety. They may restrict foreign bank operations or entry in support of these aims. They may also fear that foreign banks will not respond to government policies as do local banks, and may undermine patterns of cross-subsidization. Finally, regulators may be captured by the institutions they regulate. However, it is hard to separate these cases from those where regulators are protecting a cartel of inefficient producers because of public policy concerns.

The results of this essay suggest the following very simplified model of the regulation of foreign banks, which we would consider as a working hypothesis for further research. Countries have attitudes that incline them towards one pole or the other, i.e., towards being closed or open. Consideration of benefits from entry may move some countries that are oriented towards the closed end of the spectrum, towards the middle. Similarly, the costs of openness either to the industry or to the country will push some countries which tend to be open towards greater restrictiveness.

While we have not specifically examined the process of change in regulations in this essay, the cases and the model suggest some hypotheses. We expect costs and benefits to change slowly over time, so incremental changes probably take some time to occur. Changes in the direction of the "home" pole are probably more likely to come about than those away from it. Radical changes, i.e., those involving a switch in poles, will probably occur quite quickly. They will accompany a major change in the make-up of a government, especially due to a revolution, or in its attitudes.

If these hypotheses are correct, they have implications for lobbying efforts by foreign banks or governments. Inducing a country to change its effective polarity would seem to be very difficult, if not impossible. Even efforts to encourage a closed country to become slightly more open would

require great effort for small return. Encouraging a relatively open country to become more open would seem to hold more promise. As far as the political risk facing foreign banks operating in a country is concerned, the model suggests that incremental changes will give warning of their arrival from developments in the banking system. They will also take time to occur. Non-incremental changes will probably arrive more suddenly, and will derive from macropolitical changes in the country.

The first direction for further research is to improve the methods for measuring openness and restrictiveness, the desire for control, and the fear of dependence. With better measures of these variables the model can be improved. With better data and a better model, we can then proceed to investigate the dynamic hypotheses which we have just proposed.

FOOTNOTES

1. U.S. Treasury, Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations, Sept. 1979.
2. Ibid., Chapter 5.
3. Cramer's V is a measure of association for cross-tabulations. It is the square-root of the ratio of the chi-square statistic to the total number of cases, adjusted for degrees of freedom. Since it is always positive, it cannot indicate the direction of the association.
4. In some of the countries concerned, almost the entire banking system is foreign-owned, generally as a heritage of colonialism.
5. Countries' banking systems are designated as socialized if the national government has total or majority ownership of all the commercial banks in the country, wholly or partially foreign-owned banks aside. We reserve the term "nationalized" for banking systems in which the government permits private ownership of banks, but requires that the majority of the shares be owned by local nationals. We use the terms "publicly-owned" and "private" interchangeably to designate banks that are not government-owned. Government ownership is described as such.
6. The basic criterion used was whether the government owned the majority of the shares of at least one of the three to four largest banks in the country, based primarily on the information in the Bankers' Directory [Rand McNally International, 1978] and the Government Finance Statistics Yearbook [International Monetary Fund, 1979]. Where balance sheet data were unavailable, generally in countries with few banks, the criterion reduced to the question, "Does the government own any commercial banks"?
7. In private conversation, an officer of one of Mexico's largest banks stated that in his opinion, his bank was confident of its ability to compete. He felt that the policy of restrictiveness now owed more to a general national concern with domination by the U.S. and less to any fears on the part of the domestic banks.
8. The cases are: Bahrain, Hong Kong, Jordan, Netherlands Antilles, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
9. The two were the Ajman Arab Bank and the Janata Bank. The latter is owned by the government of Bangladesh. It has since reopened, following an infusion of capital.
10. Log odds is the term for the logarithm of the odds ratio. For two-by-two tables,  $a = \log n_{11} + \log n_{22} - \log n_{12} - \log n_{21}$  where the n's are cell frequencies. It can range between positive and negative infinity, indicating positive and negative association, respectively. A value of zero indicates independence. The variance of the log odds is given by the formula:

$$s(a) = 1/n_{11} + 1/n_{12} + 1/n_{21} + 1/n_{22}$$

Since the log odds has a Gaussian distribution around its mean, one can test hypotheses such as that the observed log odds is not significantly different from zero.

11. The four are: Chartered Bank, a British overseas bank with wide representation in Asia and which is part of the Standard Chartered Group; Bank of East Asia, from Hong Kong; Hongkong and Shanghai Bank, another British overseas bank, but with headquarters in Hong Kong; and Overseas Chinese Banking Corporation, from Singapore.
12. The six are: Creditanstalt Bankverein (Austria), Banca Commerciale Italiano, Long Term Credit Bank (Japan), Taiyo Kobe Bank (Japan), Société Générale (France, and Bayerische Vereinsbank (W. Germany). In addition, Société Générale, Banque Nationale de Paris, Creditanstalt Bankverein, Banco di Sicilia, and National City Bank of Minneapolis are reported to have representative offices in Budapest.
13. Qatar, for instance, follows the practice of placing government funds with local banks, British banks, and other foreign banks, in that order. Gabon, on the other hand, favors French banks. As we noted earlier, Malaysia bans foreign banks that are government-owned. Obviously, this will have a differential impact depending on the nature of the banking system in each potential home country.
14. The two banks were Banco do Brazil and Banco Union.
15. Earnest Schneider, EVP, Irving Trust, quoted in American Banker, Aug. 8, 1977, p. 13.
16. Islands: Anguilla, Bahamas, Bahrain, Cayman Islands, Hong Kong, Jersey, Netherlands Antilles, New Hebrides, Seychelles, and Singapore. Others: Lebanon, Luxembourg, Panama, the Philippines, Tunisia, and the United Arab Emirates.
17. The four are: Bahrain, the Philippines, Singapore, and Tunisia.
18. As far as political systems are concerned, Gastil [1978, pp. 43-51] recognizes four major types, with seven subtypes. For our purposes, we distinguish only two: the multiparty category and the socialist or communist one-party system category. Whenever we use either of these categories, all other systems are thrown into a residual category. Multiparty states do not include those where one party so dominates that any and all other parties exist in little else but name.
19. Gastil develops a four-fold typology of economic systems: capitalist, capitalist-statist, capitalist-socialist, and socialist. The characterizations are impressionistic and the dividing lines are necessarily arbitrary. In capitalist states, there is a general reliance on the operation of the market and on private provision for individual welfare. Capitalist-statist governments own very large productive enterprises and intervene in the economy in a major way, but not primarily on egalitarian



grounds. Capitalist-socialist systems provide social services on a large scale, with the result that some private control over property is sacrificed. In socialist states, the government strives programmatically to place the entire national economy under its control.

While Gastil does not make this clear, the typology actually reflects two dimensions--one involving the degree to which the government directs the economy, and the other its commitment to redistribution on egalitarian grounds. Thus, following the first dimension, we would group the capitalist and capitalist-socialist types on the one hand, and the capitalist-statist and socialist types on the other. On the second dimension, we would group capitalist with capitalist-statist types, and capitalist-socialist with socialist types.

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