

# Regional Integration and Foreign Direct Investment in Banking Sector: Three Case Studies

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(First draft)

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## Abstract

Using a panel dataset of bilateral flows of banking sector foreign direct investment (FDI) in developed and developing countries, we study the impact of regional integration agreements (RIAs) on the location of banking sector FDI. The results indicate that the impact of RIAs vary depending on different kinds of regional integration. The response to integration between developed countries (North-North integration) may differ from the response to integration between developing countries (South-South integration) or to an agreement between countries at different levels of development (North-South integration), depending on the significance and nature of environmental change brought about by the RIAs, the locational advantage of the country or region and the degree of integration at the outset. The RIAs between developed countries had relatively little influence on foreign bank entry, since much of the financial service trade between the member countries had been liberalized long before the agreement was established. By contrast, North-South integration agreements and South-South integration agreements brought about significant region's policy environment changes and more proximity institutional, which suggests that they may have a notable (although varying) impact on banking sector FDI in the member countries.

Keywords: Regional integration agreements, banking sector, FDI.

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## Introduction

The 1990s witnessed a spread of Regional Integration Agreements (RIAs), including many between developing countries. Among the newly created RIAs are MERCOSUR, ASEAN, NAFTA, and the Cross-Border Initiative. Existing RIAs have also been revived and have increased their membership. Many developing countries are in an RIA or are discussing the possibility. Although some integration agreements have been motivated by political considerations, it is clear that economics is generally the driving force: countries enter into RIAs because integration promises various economic benefits. In the short run, integration is expected to stimulate intra-regional trade and investment; in the longer run, it is hoped that the combination of larger markets, tougher competition, more efficient resource allocation, and various positive externalities will raise the growth rates of the participating economies.

At the same time, the world has been experiencing a dramatic surge in FDI which involves flows toward both developed and developing countries.

In light of these developments, the role of regional integration agreements as a determinant of the location of FDI has become an increasingly relevant issue for developed and developing countries. It has been explored in a myriad of theoretical and empirical papers by trade economists who analyse both the rationale of regionalism and its possible implications.

Since the impressive increase in FDI was largely driven by increases in FDI in services, and in particular financial FDI (FFDI), finance economists have been producing an impressive amount of work on the causes and implications of the internationalization of the banking Sector. The existing literature on foreign bank entry discusses the following factors as potential drivers of foreign bank participation: (a) banks' desire to service their customers abroad— the so called “follow the clients” motive, (b) host-specific factors including market opportunities and regulatory barriers and (c) economic and cultural ties and institutional and regulatory similarities between home and host countries<sup>2</sup>.

These two branches of existing literature, however, have never met. The large studies that approach the question of location of foreign banks shows a substantial evidence that these micro and macro factors influence the decision of banks to operate overseas. Contrary to the wealth of evidence on these determinants, the role that Regional Integration Agreements (RIAs) and its type can play in bringing about foreign bank participation has not been discussed. Similarly among the studies of regionalism there is a large literature on the costs and benefits of Regional Integration Agreements on trade in goods and real FDI, and hardly any analysis of the implications of such agreement in services. This is surprising because nearly every major RIAs now has a services dimension.

The attraction of FFDI in the emerging markets was seen by policymakers as beneficial to the global financial system. The arguments in principal resemble those in favour of real

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<sup>2</sup> See for example Claessens et. al. (1998) Focarelli, D., F. Pozzolo (2000) and Cull, R. (2007) for cross section studies on Foreign Bank location

FDI. FFDI can be expected to contribute to the efficiency of host country financial systems through technology transfer and heightened competition. Entry by foreign bank, well capitalised institutions with sophisticated risk management was also viewed as beneficial for financial stability. Moreover, banking sector FDI was expected to be a source of non-debt external financing for countries emerging from periods of economic and financial disturbances.

In this way and as in the realm of trade and FDI in goods, FFDI liberalization may, and has been pursued unilaterally or on a preferential basis. The purpose of this paper is to approach the issue of the role of RIAs as a determinant of the location of foreign banks from a theoretical and empirical point of view. A difficulty in assessing this role is that there are many channels through which RIAs could potentially have an impact on the banking FDI<sup>3</sup>. For these reasons, we will focus on how the type of RIA will affect its impact on the location of foreign banking investment and we will attempt to cover several different integration types by three case studies in the empirical part of the paper.

This communication will be articulated around three essential points:

1- Beyond the traditionally advanced theoretical justifications, we make the assumption that the impact of these agreements on flows of IDE depends on the level of development and the institutional proximity between country of origin and host country. It is because these agreements impose to the partners a certain number of reforms and levellings institutional and organisational which they can influence flows of FDI. If quantitative variables such that the size of the market and its growth rate, the labour available, its cost, its qualifications hope in the decision to be established abroad, in the case of services and particularly in the case of financial services, it is especially the control of the contractual variables which validate this decision and explain the passage to the act. The foreign investors require being reassured on the extent of the protection that ensures them the agreements between their country of origin and the host country. This built institutional proximity causes to reduce the risks related to the establishment in foreign countries. The countries transmitting IDE export their standards thus.

2- To undertake a study of the tendency of FFDI, it is essential to examine the institutional arrangements of the multilateral framework of liberalization of trade and services and of different regional agreements in place. Many thorough studies (Morner (2000), Gardener (2000) and Frankel, J.A. (1996)) analyse in depth this institutional arrangements so I shall limit myself in this paper to a simplified description of the most results of the GATS negotiations and of the main aspects pertinent to FFDI in each of the selected major RIAs.

3- To evaluate how the type of RIA initiative may affect its impact on FDI in banking sector, we presents three case studies focusing on different kinds of regional integration : North-North integration (Canada in CUSFTA), North-South integration (Mexico joining NAFTA), and South—South integration (MERCOSUR). The investment experiences in general and the financial one in particular of small, open economies are arguably more heavily influenced by international economic developments, such as regional integration, than those of relatively large economics (US and the major EU members countries). The choice of countries for the case studies has largely been conditioned by this consideration.

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<sup>3</sup> Levy Yeyati, E., E. Stein and C. Daude (2004)

## I. Regional Integration Agreements and FDI: theoretical considerations

Parallel to the movement of liberalization and universalization of the years 1980, one attended a multiplication of regional integration agreements which do not relate to any more from now on only countries of equal development. Indeed, North-South regional integration between industrialized countries and developing countries will introduce new stakes.

### 1) Traditional explanations

To analyze the effects of economic integration or the impact of the agreements of regional integration on the economies of the countries partners, the economists have recourse mainly to the theory of the international trade and with the theory of the FDI. The theory of the trade international is interested in the effects of these agreements on the localization of the industrial activities and the distribution of the provisioning of the local markets by imports or local production. It is not interested in nationality of control of the activities nor moreover to the actors responsible for these exchanges (Dunning, 1997). It does not tackle the questions of property but primarily the question of knowing if the FDI and the trade are substitutable or complementary, and what determines the choices of the localization of the firms in a vast space integrated where the territories are put in competition. Since one has recourse to the theory of the IDE, are explicitly put the questions holding with the nature of the property according to whether it is national or foreign. “..., *the theory of the FDI examines the impact of integration on the competitive advantages of the firms of various nationalities, the localization of the activities associated with these competitive advantages and the means by which these advantages are organized jointly with the possibilities of resources of the countries hosts*” (Dunning, 1997). In the theoretical analyses of the impacts of the FDI, one often finds one combination of the two approaches.

The impacts of the RIAs forward by several vectors. On the one hand, they will be positive for the FDI coming from the outside of the zone (outsiders) but have unforeseeable effects for the intra-regional FDI (Blömstrom and Kokko, 1997). In this last case, all depends on the nature of the FDI and thus of the strategies of the firms. Within the framework of the installation of the single market, Dunning (1997) highlighted in the case of the EU who the extra community IDE had been more important during the first phase of integration.

Within the framework of the relations between developed countries and developing countries, those things are relatively different bus the types of exchanges are them even different. Indeed, the movements of FDI which integrated the developing countries traditionally were rather of vertical nature whereas since the Eighties, they are also of horizontal determined by the attraction of foreign markets in growth. In addition, the requirement of flexibility and reactivity at the markets which had caused phenomena of re-localization seems to move back in front of requirements of lightening of costs in a context where competition becomes sharper on certain markets because of rise to power of China. These transformations thus induced a change in the relative importance of the various determinants traditional of the FDI. Thus, the wage costs are more one determining

fundamental only for certain traditional sectors or in the sector of the services. The factorial equipments also moved back in front of the specific factors. The essential determinants become the importance of the investment in R-D, the accessibility to the new markets, the size of the markets, the proximity which allows the production in tended flows, the specific human capital, the quality of the infrastructure, transport and the means of telecommunications and 'offer of local coordinations'.

## 2) The role of the institutions

However, it is noted that beside the traditional determinants, the institutional proximity between the countries of origin and the host countries count independently of the level of the GDP per capita generally regarded as a determining factor of the attractivity. However, the traditional approaches do not take into account the production of standards, rules, procedures of decision and institutional levelling implementations in the contemporary forms of regional integration between countries with different level of development. In the same way, certain historical aspects concerning the relations between member countries of the emergent RIA in the field of the trade and the FDI before the signature of the agreement seem to play an important part in the decisions of localization once agreement is signed. It is about a whole of variables of non-commercial nature that certain authors gather under the term of proximities and that others will gather under the term of "good governorship". All things being equal in addition, in terms of size of market, competitiveness cost etc, offering countries of the proximities in terms of language, of mode of organization of the productive systems, commercial practices of negotiation, whose elites were formed in the same university structures will have more motivations to widen their co-operation in the industrial and commercial field via the IDE.

Relations between country of the zone in the field of the trade and the IDE before signature of the agreement thus play an important part in the decisions post-agreement. Indeed, the agreement reinforces or comforts the confidence of the investors who already have (or which had) interests in the countries in question. This idea that the history counts in the analysis of the effects of the regional integration agreements makes necessary to study stocks of IDE before and to put them in relation to the origin and the destination of flows. In spite of the diversity of the historical trajectories, one often observes a similarity between the institutions of the old countries administrators and the young emergent countries which remained to them bound by privileged trade. The transfer of politico-administrative models of organization often set up after independence allowed a diffusion of the modes of operation of the various public and private organizations. For example, in a sector-key as that of the bank, parallel to the various financial reforms, the effects of training of the banking executives in the structures of the French banks be via the systems of continuous training which were attached with the CFPB<sup>4</sup>, made it possible to preserve and to diffuse the French model of organization and operation in south-Mediterranean countries that were signed a bilateral integration agreements. In parallel, the plans of structural adjustment, the rules of WTO, the conditions of levelling and the installation "of a good governorship" take part jointly with the agreements of Barcelona in the construction of an institutional environment similar to that of the developed countries. Association at the EU is accompanied at the same

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<sup>4</sup> Centre de formation de la profession bancaire, structure française de la formation continue spécialisée dans la banque

time by financial and institutional transfers because each of the Eastern and south countries of the Mediterranean must develop its capacity to be reformed. The system of conditionality of the IMF and the World Bank within the framework of the plans of structural adjustment are taken again by the EU. Beyond the re-establishment of macro-economic balance, certain countries must still look further into their structural reforms and thus continue privatizations, the reform of the financial system, the fight against corruption etc. Even if the requirements are not the same ones as for the candidates with integration in the EU, stowing in Europe implies certain numbers institutional transfers with an aim of improving the economic environment of the Eastern and south countries of the Mediterranean. The institutions must offer an attractive framework, controlled, sure, compatible with the standard framework of reference of the market economies. This framework defining it what must be "a good quality of institutions " includes the tax system, the facility to create a company, the absence of corruption, the transparency and the accessibility to information, the protection of the rights of ownership, the effectiveness of justice, the laws contractual, the prudential standards, a competing framework, etc. More the institutions of the transmitting countries and the receiving countries of FDI are close, more them flows of FDI will be important independently of the level of the GDP per capita. This proximity institutional built has as an important effect if not more as the simple proximity geographical.

If the regional integration of a developing country at a developed zone (South-North RIA) enables him in certain cases to increase the possibilities of correction, especially in terms of institutional and organisational standards, and to reduce the cumulative effects of the initial divergences between the two zones, it also causes to offer to the foreign investors new profit opportunities. The FDI tend to be directed more naturally towards the developing countries integrated in a RIA than towards the others (Jaumotte, 2004).

This type of integration thus produces a certain number of consequences on creation, the orientation or the reorientation of flows of IDE towards certain countries of the RIA member which concluded from the horizontal agreements resulting in' widening their market. The agreements of Barcelona which followed upon the agreement of Marrakech signed in April 1994 will make it possible the countries of the EU to operate a correction in terms of North-South regionalization compared to the other large poles of the triad. For the countries of the South, these agreements contribute to increase their attractiveness, goal of all the industrial policies of the Nineties.

However, if the stress is laid on the capacity to attract FDI, one should not therefore to occult that for certain countries of the south, the FDI are not a phenomenon recent. However, the innovation lies at the same time in the change of the international institutional environment which tends to be homogenized and in the evolution of the strategies of the firms. At the same time total and regional institutional changes (adoption of common standards and widening of the field of competition) and nationals (liberalization, deregulation, privatization) created new opportunities in a world more open and made up of heterogeneous zones from the point of view of the level of development. Indeed, if the firms established in certain south countries during period 1920-1960 hoped to control their sources of provisioning, to feed the local markets and to produce at low cost to export towards the markets of the north counties, those which invest in the south countries at the end of the Nineties and during years 2000 have strategies of repositioning within the framework of a

widened integrated regions with several countries but also strategies of control of certain activities on a world market scale.

## **II. The liberalization of FFDI at the multilateral and regional level**

In this section I will not study in depth the institutional arrangements of the multilateral framework of liberalization of trade and services and of the different regional agreements in place<sup>5</sup>. I shall limit the description here to the most salient results of the GATS negotiations, in first on the basis of an index of restrictions which was computed using the GATS schedules only and in the second on the basis of an index of restrictions which was provided using a large number of sources and included several different types of restrictions (Golub 2003, 2006). The second part of this section is devoted to a brief description of the main aspects pertinent to FFDI in each of the RIAs (CUSFTA, NAFTA and MERCOSUR) covered in this paper.

### 1) The multilateral liberalization of the financial services

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

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

However, Golub (2003) and (2006) mentioned that the GATS schedules by themselves are poor guides to the stance of policies towards FDI for most countries and generally underestimate the extent to which countries have opened up their financial service sector to FDI. While taking into account several different types of restrictions, such as limitations on foreign ownership, screening or notification procedures, management restrictions, and operational restrictions, he provides a study contains a more comprehensive and up-to-date compilation, quantifications and analysis of restrictions on FDI in banking services in

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<sup>5</sup> See for example Empel and Mörner (2000), Gardener(2000) and Frankel,J.A. (1996)

developing and developed countries. As the banking FDI restrictions scores shows the most open developing countries tend to be in Latin American and Central and Eastern Europe. East, South-East and West Asia tend to be more restrictive (see annex Table 3).

## 2) Regional Integration Agreements

*CUSFTA* is the 1988 Canadian-US free trade agreement, which lifted many entry barriers to the provision of financial services between the two countries.

The essence of the CUSFTA was the phased bilateral elimination of tariffs. In addition, a number of provisions reduced discrimination against bilateral foreign direct investment, including the extension of rights-of-establishment and national treatment. A range of prominent sectors, such as basic telecommunications, was effectively excluded from coverage under the investment liberalization provisions of the Agreement. Moreover, Canada's existing foreign investment screening procedures were left in place (see Annex table 2: Restrictions scores). Nevertheless, the thrust of the investment provisions of the CUSFTA was clearly to expand the legal scope for bilateral direct investment. Moreover, the inclusion of a relatively robust dispute resolution procedure arguably reduced the risks of either government acting in a discriminatory manner towards investors from the other country.

*NAFTA* is signed by Canada, Mexico and the United States and entered into force in January 1994. Like the EU, NAFTA explicitly considers the liberalization of financial services but, unlike the European agreement, NAFTA keeps the supranationality at a minimum, relying rather on working groups to deal with different issues of economic integration. The Financial Committee supervises the functioning of the agreement and there is a dispute settlement mechanism specific to financial services. A non complying party may have its benefits in the financial sector suspended.

Since CUSFTA had already liberalized financial services between Canada and the United States, the largest impact of NAFTA was to be for Mexico. Concerns regarding the Mexican banks' ability to withstand open competition from US and Canadian banks resulted in a delayed schedule for the opening of the Mexican financial system. The country was allowed to maintain share limits during a transitional period ending in 2000, when US and Canadian banks were to be allowed in an unrestricted way. The peso crisis of 1994 however, accelerated the financial reform in Mexico. As a standard response to him the government, encouraged by the international financial institutions, accelerated financial liberalization and to recapitalize banks with the help of foreign investors. In the aftermath of the crisis, the Mexican authorities were forced to intervene many banks that could not continue to operate as solvent entities (see Pablo Graf 1999 for a detailed description of the crisis and the ensuing reforms of the Mexican banking sector). The lack of domestic resources to re-capitalize the industry led the authorities to lift some restrictions on the foreign ownership of banks.

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



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

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

### **III. Empirical study of regional integration and FDI in banking sector: three distinct cases of agreements**

The theoretical discussion concluded that it is difficult to make general predictions regarding the results of RIAs on foreign direct investment decisions in banking sector. The response to an integration agreement will depend on the significance and nature of environmental change brought about by the RIA and the locational advantage of the country or region in question. Consequently, effects are likely to vary between small and large countries, developed and developing countries, and different integration agreements.

In this section, we will attempt to assess how the type of RIA will affect its impact on the location of foreign banking investment and, to cover several different integration kinds, we have chosen to examine the effects of three distinct cases of regional integration agreements:

- North-North integration agreement, as illustrated by the impact of the CUSFTA on Canada,
- North-South integration agreement, focusing on Mexican participation in the NAFTA, and
- South-South integration agreement, exemplified by the establishment of the MERCOSUR.

#### 1) North-North integration agreement : Canada in CUSFTA

To the extent that CUSFTA significantly liberalized the North American trade environment, one would expect to see bilateral trade between the United States and Canada becoming relatively more important from 1988 onward. Moreover, to the extent that trade and foreign direct investment are significantly related - either as substitutes, as suggested by models of tariff-jumping FDI, or as complements, as implied by internalization theories - one

would also expect to see changes in the relative importance of bilateral direct investment in general and in banking sector between the two countries.

Table1. *FDI in banking sector of Canada (1995-2005)*

Table shows the share of assets (as a percentage of total banking sector assets) held by foreign banks\* from US and from other countries.

Year	Domestic	Foreign	Foreign	
			US	Other
1995	95,9	4,1	0,10	4,00
1996	95,3	4,7	0,12	4,58
1997	95,7	4,3	0,13	4,17
1998	94,8	5,2	0,11	5,09
1999	94,6	5,4	0,12	5,08
2000	93,9	6,1	0,13	5,98
2001	93,5	6,5	0,17	6,33
2002	92,9	7,1	0,14	6,96
2003	92,3	7,7	0,18	7,52
2004	91,7	8,3	0,16	8,14
2005	91,9	9,1	0,15	8,95

\* A foreign bank is defined to have at least 50 % foreign ownership

Data source: BankScope database

Table 1 presents an overview of the foreign direct investment in Canadian bank system between 1995 and 2005. Certainly there is no consistent evidence of any lasting diversion of US banks penetration to Canada in response to CUSFTA. However our observations suggest a concurrent increase in the banks' foreign direct investments from the rest of the world, presumably because the CUSFTA made Canada a more attractive investment location for outsiders firms and thus for banks that follow their customers.

Canada offers a potentially instructive case study of the impacts of a RIA on foreign direct investment flows for a small open economy. Since economic theory makes no compelling case for a strong linkage between RIAs and FDI patterns for individual countries, and since the environmental change connected with the CUSFTA was not dramatic, on the one hand it is hardly surprising that the pattern of US banks' foreign direct investment into Canada over the past years does not suggest a strong and consistent influence of the agreement. On the other, it seems reasonable to characterize the Canadian position with moderate changes resulting from the agreement. In this context, it should be remembered that bilateral trade between Canada and the US had been substantially liberalized well before the event studied here, through successive GATT rounds as well as special bilateral agreements such as the Auto Pact and the Defense Sharing Agreement. Thus one can not attend a rather important "institutional proximity built" within the framework of the new agreement (CUSFTA) and which will normally have like answer an increase of the foreign bank entry (Claessens S. and Neeltje Van Horen (2006)), institutional convergence between the two countries already exists before the agreement. Hence, we should expect relatively moderate US banks' direct investment effects of the agreement for Canada.

Nevertheless, the Canadian experiences serve as a caution against anticipating substantial banks' foreign direct investment impacts for smaller economies joining RIAs and especially in the case of the North-North integration agreement.

## 2) North-South integration agreement : Mexico in NAFTA

Since CUSFTA had already liberalized financial services between Canada and the United States, the largest impact of NAFTA was to be for Mexico.

The share of assets held by foreign banks in Mexico has dramatically increased, from 2,3 percent 1995 to over 83 percent in 2005, as shown in table 2. The North American assets share in Mexican foreign banks assets has also grown over this period, but not quite as dramatically. The reason to expect positive implications of the free trade arrangement for the Mexican economy is related to the significant policy changes that have taken place in recent years. Traditionally, Mexico has been a closed economy. In the mid-1980s, however, important market-oriented reforms were introduced in several sectors, and the economy began to open up. As a consequence of the NAFTA, the reform process has been "locked in" and extended to many sectors, such as finance. The reforms themselves were fostered by the general climate favouring privatization, deregulation and reliance on market mechanisms, the gradual erosion of the effectiveness of and policy support for capital account regulation, and the influence of international financial institutions in promoting greater integration into the global economy and more robust domestic financial systems.

The coincidence of policy reforms, institutional convergence towards international standards and distinct locational advantages in the form of free access to serve a substantial part of the Canadian and US markets, make the Mexican banking sector very attractive for the foreign penetration from insiders and outsiders of the RIA member. In addition, it is quite clear that foreign multinationals have noted and reacted on the recent changes in Mexico. To the extent that Mexico has become a relatively more important supplier to the US market through trade creation or trade diversion, foreign multinationals are likely to respond by increasing their implantation in Mexico, what will have as a consequence an increase of the entry of foreign banks that follow their firms' customers.

Table2. *FDI in banking sector of Mexico*

Table shows the share of assets (as a percentage of total banking sector assets) held by foreign banks in Mexico.

Year	Domestic	Foreign	Foreign	
			NAFTA*	Other
1995	97,7	2,3	1,2	1,1
1996	95,5	4,5	1,4	3,1
1997	92,7	7,3	2,1	5,2
1998	92,4	7,6	2,7	4,9
1999	89,9	10,1	3,9	6,2
2000	71,3	28,7	8,3	20,4
2001	69,7	30,3	10,1	20,2
2002	38,2	61,8	20,2	41,6
2003	37,3	62,7	21,5	41,2
2004	32,8	67,2	23,7	43,5
2005	16,7	83,3	24,9	58,4

\* Other NAFTA's member; Canada and USA

Data source: Bank Scope database

The experience of Mexico suggests that North-South integration may be greatly beneficial for the Southern partners, and illustrates some of the prerequisites for achieving these beneficial effects. Firstly, membership in the NAFTA coincided with other reforms that liberalized the institutional framework of the country. Hence, the RIA contributed to a very significant institutional proximity and a positive environmental change. Secondly, Mexico possesses strong locational advantages with respect to its northern neighbours. These are made up of increasingly market oriented economic policies, and geographical proximity. Consequently, regional integration has been connected to significant increases in the level of foreign banks investment, in particular from countries outside the NAFTA region. In other words, Mexico is a good example of a country that would be classified in level 1 in our template of possible outcomes of regional integration agreements.

### 3) South-South integration agreement : MERCOSUR

Table3. *Foreign Direct Investment Banking Sector of MERCOSUR members*

Table shows the share of assets (as a percentage of total banking sector assets) held by foreign banks.

Year	Argentina	Brazil	Paraguay	Uruguay
1995	25,4	8,9	69,4	24,3
1996	29	9,8	56,3	14,2
1997	37,1	14,7	74	18,3
1998	40,1	15,3	76,7	25,1
1999	39,4	17,8	77,4	30,7
2000	48,2	26,9	79,8	32,4
2001	44,4	30,3	80,7	35,5
2002	37,8	28,9	81,2	34,2
2003	38,4	27,4	83,4	40,1
2004	40,1	27,7	83,6	42,8
2005	42,5	28,1	84,4	50,2

Source: BankScope database

First, these aggregate data do not distinguish between intra and inter-regional foreign bank participation, but the dominate share of the North banks assets in total foreign assets, shown in table 4, suggest that a significant share of the banking FDI com from outside the MERCOSUR. So the additional effect of this RIA does not seem to have taken place at the expense of the share of foreign banks assets from the rest of the world.

Table4. *Share South banks assets\*, versus share North banks assets on total foreign Assets of MERCOSUR member (in percent)*

	Argentina	Brazil	Paraguay	Uruguay
Share South banks assets in total foreign assets	0,02	0,01	0,20	0,20
Share North banks assets in total foreign assets	0,98	0,99	0,80	0,80
Share South foreign	0,17	0,07	0,44	0,24

banks in total				
foreign banks				

\* South banks assets were assets of foreign banks (average over 2000-2004) from all developing countries including other MERCOSUR member  
Source: Neeltje Van Horen (2006)

Second, the dramatically increase of foreign banks entry to the region between 1995 and 2005, shown in table 3, was not of an equal level to all participating countries.

Argentina registered a very large increase in foreign banks’ direct investment since 1995, and there is reason to expect that much of this was unrelated to the regional integration process. The most important attraction for foreign banks investors was arguably Argentina’s comprehensive privatization program, which opened not only financial service but also several public service industries to foreign investment. Another important determinant was the country’s successful macroeconomic reforms, which managed to bring down public deficits, inflation, and interest rates, and ensured the convertibility of the currency.

The foreign banks investment in Brazil has increased widely during the past years, and the share of foreign banks participation remains even less important than in Argentina, although the Brazilian market is about four times larger. One reason is that market-oriented reforms were introduced later and macroeconomic stabilization was achieved later in Brazil than in the other countries in the region. Consequently, the positive prospects connected with regional integration were tempered by an unpredictable macroeconomic environment. However, the recent years have witnessed successful reforms and stabilization in Brazil as well and the foreign banks assets have increased markedly and reached over 27 percent of the total Brazilian banks assets. Other reason is the strong locational advantages of Brazil in terms of its large market; suggest that we should expect substantial inflows of real foreign investment and as a consequence an increase of the entry of foreign banks that follow their firms’ customers.

The experiences of the two smaller countries in the region, Paraguay and Uruguay, are mixed. While in the two cases the share of foreign banks seems to have increased, there is no similar source of foreign participation. Uruguay is arguably more attractive for extra-bloc investors because of its geographical location between Brazil and Argentina and as a consequence more attractive for the north foreign banks that follow their firms’ customers (table 4 shown that the share of south foreign banks in total foreign banks is only 24 percent). The smallest country of the Agreement, Paraguay, has benefited from intra-bloc banking FDI if not from foreign banks’ direct investment from the rest of the world. The locational advantages of Paraguay are weaker for extra-bloc banking investors and especially for north investors but still important for the intra-bloc banking investors that search to profit from the “first-mover advantage” which can be provides by the access to preferential market.

## Conclusions and directions for future research

The economic theory does not provide any general prediction regarding the impact of RIAs on foreign banks’ investment decision. A difficulty in assessing this role is that there are many channels through which RIAs could potentially have an impact on the banking FDI. For instance, the impact of a RIA may be affected by its type. The effects of agreements between developed countries (North-North RIAs) may differ from integration between developing countries (South-South RIAs) or agreements between countries at different levels

of development (North-South RIAs), depending on how competitive the domestic bank system is, how much an institutional proximity is construct by the agreements, and how much integrating there is at the outset. Regional integration is likely to have different effects on investors from the participating economies and outside investors, particularly if the agreements are discriminatory in the sense that significant barriers against the rest of the world remain after regional trade and investment are opened up. Hence, specifying the exact relation between RIAs' type and banking FDI is essentially an empirical question.

The three cases presented in the second part of the paper highlighted some of the cross-country differences in the foreign banking investment effects of regional integration. The first case focused on the Canadian participation in the CUSFTA, and illustrated a situation where the RIA did not appear to cause any radical changes in the US banks' entry to the country in question. The main reasons for the moderate impact of the CUSFTA are probably that the environmental change connected with the agreement was not dramatic (since trade between Canada and the US was already relatively free due to GATS commitments and various bilateral treaties) and that there was already institutional proximity who results in considerable cross-investment between the two countries in banking sector.

The second case examined the impact of the NAFTA agreement on foreign banks' investment in Mexico, and suggested that this specific RIA has had a profound impact on the share of foreign banks assets in total banks assets. There are several reasons for this impact. Firstly, the establishment of the NAFTA coincided with and deepened other reforms that liberalized the institutional framework of the country. Hence, the agreement contributed to very significant and positive environmental changes. Secondly, due to its increasingly market oriented economic policies and geographical proximity, Mexico possesses strong locational advantages. Consequently, regional integration has created an abundance of new commercial opportunities for domestic and foreign investors, in the domestic Mexican market as well as in the US and Canadian markets. The response has been a significant increase in the foreign bank direct investment inflows, in particular from countries outside the NAFTA region and in particular that which follow their firms' customers. The Mexican experience is likely to capture some general characteristics of North-South agreements, primarily related to the potential for improved policy credibility and gains from guaranteed access to large northern markets.

In the case the Mercosur, the combined effect of national policies and the regional agreement has meant a significant increase of foreign bank entry from all sources in Argentina, Brazil and Uruguay. The smallest country of the Agreement, Paraguay, has benefited from intra-bloc banking FDI if not from banking FDI from the rest of the world.

The case studies methodology has the advantage that one can take into account the institutional detail of the countries under study when reaching conclusions about the impact of integration on FDI. At the same time, however, it illustrates the difficulty of drawing strong conclusions when so many other variables complicate the particular cases. In Mercosur, for example, it is hard to disentangle the effect of the RIA from that of macroeconomic stabilization, which occurred at approximately the same time. In Mexico, the effect of NAFTA is hard to distinguish from that of other changes in FDI-related policies that took place. Moreover, the particular circumstances of each of the cases studied make it

difficult to extrapolate the findings to other potential RIAs, particularly when these do not share the same context even if it is of the same kind. To what degree was banking FDI influenced by the unique circumstances of each set of countries and to what degree was it driven by their RIA type? Case studies, however well informed, cannot provide definitive answers. Another way to proceed, which provides a nice complement to the case studies, is to control for some of those circumstances within a large sample of developed and developing countries all of which are sources or hosts of FDI, and are parties to several kinds of RIAs to try to sort out quantitatively the effects of an RIA from the effects of other circumstances.

## Annex

Table1: Selected Major Regional Integration Agreements

RIA	Members
<i>Industrial and developing Economies</i>	<p><i>European Union (EU)</i>: formerly European Economic Community (EEC) and European Community, 1957: Belgium, France, the Federal Republic of Germany, Italy, Luxembourg, the Netherlands; 1973: Denmark, Ireland, United Kingdom; 1981: Greece; 1986: Portugal, Spain; 1995: Austria, Finland, Sweden.</p> <p><i>European Economic Area</i>: 1994: EU, Iceland, Liechtenstein, And Norway.</p> <p><i>Euro-Mediterranean Economic Area (Euro-Maghreb)</i>: Bilateral agreements, 1995: EU and Tunisia; 1996: EU and Morocco.</p> <p><i>EU bilateral agreements with Eastern Europe</i>: 1994: EC and Hungary, Poland; 1995: European Community and Bulgaria, Romania, Estonia, Latvia, Lithuania, Czech Republic, Slovak Republic, Slovenia.</p> <p><i>Canada-U.S. Free Trade Area</i>: 1988: Canada, United States.</p> <p><i>North American Free Trade Area (NAFTA)</i>: 1994: Canada, Mexico, United States.</p> <p><i>Asia Pacific Economic Cooperation (APEC)</i>: 1989: Australia, Brunei Darussalam, Canada, Indonesia, Japan, Malaysia, New Zealand, Philippines, the Republic of Korea, Singapore, Thailand, United States; 1991: China, Hong Kong (China), Taiwan (China); 1993: Mexico, Papua New Guinea; 1994: Chile; 1998: Peru, Russia, And Vietnam.</p>
<i>Latin America and the Caribbean</i>	<p><i>Andean Pact</i>: 1969: revived in 1991, Bolivia, Colombia, Ecuador, Peru, Venezuela.</p> <p><i>Central American Common Market (CACM)</i>: 1960: revived in 1993, El Salvador, Guatemala, Honduras, Nicaragua; 1962: Costa Rica.</p> <p><i>Southern Cone Common Market (Mercado Común del Sur—MERCOSUR)</i>: 1991: Argentina, Brazil, Paraguay, Uruguay.</p> <p><i>Group of Three</i>: 1995: Colombia, Mexico, And Venezuela.</p> <p><i>Latin American Integration Association (LALA)</i>: formerly Latin American Free Trade Area, 1960: revived 1980, Mexico, Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, Venezuela.</p> <p><i>Caribbean Community and Common Market (CARICOM)</i>: 1973: Antigua and Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago; 1974: Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent and the Grenadines; 1983: The Bahamas (part of the Caribbean Community but not of the Common Market).</p>
<i>Sub-Saharan Africa</i>	<p><i>Cross-Border Initiative</i>: 1992: Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.</p> <p><i>East African Cooperation</i>: 1967: formerly East African Community broke up in 1977 and recently revived Kenya, Tanzania, and Uganda.</p> <p><i>Economic and Monetary Community of Central Africa</i>: 1994: formerly Union Douanière et Economique de l’Afrique Centrale, 1966: Cameroon, Central African Republic, Chad, Congo, Gabon; 1989: Equatorial Guinea.</p> <p><i>Economic Community of West African States (ECOWAS)</i>: 1975: Benin, Burkina Faso, Cape Verde, Côte d’Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo.</p> <p><i>Common Market for Eastern and Southern Africa</i>: 1993: Angola, Burundi, Comoros, Djibouti, Egypt, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Rwanda, Somalia, Sudan, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.</p> <p><i>Indian Ocean Commission</i>: 1984: Comoros, Madagascar, Mauritius, Seychelles.</p> <p><i>Southern African Development Community (SADC)</i>: 1980: formerly known as the Southern African Development Coordination Conference, Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia, Zimbabwe; 1990: Namibia; 1994: South Africa; 1995: Mauritius; 1998: Democratic Republic of the Congo, Seychelles.</p> <p><i>Economic Community of West Africa</i>: 1973: revived in 1994 as West African Economic and Monetary Unit, Benin, Burkino Faso, Côte d’Ivoire, Mali, Mauritania, Niger, Senegal.</p> <p><i>West African Economic and Monetary Union</i>: 1994: Benin, Burkina Faso, Côte d’Ivoire, Mali, Niger, Senegal, Togo, 1997: Guinea-Bissau.</p> <p><i>Southern African Customs Union (SACU)</i>: 1910: Botswana, Lesotho, Namibia, South Africa, Swaziland.</p> <p><i>Economic Community of the Countries of the Great Lakes</i>: 1976: Burundi, Rwanda, Democratic Republic of the</p>

<i>Middle East and Asia</i>	<p>Congo.</p> <p><i>Association of Southeast Asian Nations (ASEAN): 1967:</i> ASEAN Free Trade Area was created in 1992, Indonesia, Malaysia, Philippines, Singapore, Thailand; <i>1984:</i> Brunei Darussalam; <i>1995:</i> Vietnam; <i>1997:</i> Myanmar, Lao People's Democratic Republic; <i>1999:</i> Cambodia.</p> <p><i>Gulf Cooperation Council (GCC): 1981:</i> Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.</p> <p><i>South Asian Association for Regional Cooperation: 1985:</i> Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka.</p>
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Source: WTO data.

Table 2: Equity restrictions and government ownership in banking services of selected countries, 2004 or latest available year

Country	Restrictions scores *	Permissible foreign share
Argentina	0,100	No restrictions
Brazil	0,430	50%- 99%
Canada	0,575	1% - 49%
Mexico	0,350	50%- 99%
Paraguay	0,150	No restrictions
Uruguay	0,600	1% - 49%
USA	0,150	No restrictions

\*See Table 3 for the system of notation used to calculate the total score of restrictivity in banking sector of each country.

Source: Golub, S. (2003) and (2006).

Table 3 : Coefficients on FDI restrictions (Maximum 1.0)

Type of restriction	Scores
<i>Foreign equity limits</i>	1
No foreign equity allowed	0.6
1 to 19 % foreign equity allowed	0.4
20-34% foreign equity allowed	0.3
35-49 % foreign equity allowed	0.2
50-74% foreign equity allowed	0.1
75-99% foreign equity allowed	0.05
No restriction but unbound	
<i>Screening and approval</i>	0.2
Investor must show economic benefits	0.1
Approval unless contrary to national interest	0.05
Notification (pre or post)	
<i>Other restrictions</i>	
Board of directors/Managers	0.1
Majority must be nationals or residents	0.05
At least 1 must be national or resident	0.025
Must be locally licensed	
Movement of people	0.1
No entry	0.075
Less than one year	0.05
One to two years	0.025
Three to four years	
Input and operational restrictions	0.1
Domestic content must be more than 50%	0.05
Other	
Total*	Between 0 and 1

\* If foreign equity is banned, then the other criteria become irrelevant, so that the index is at 1.0. It is possible that various scores sum to slightly more than 1.0 when foreign equity is not totally banned, and in such cases, the index is capped at 1.0.

Source: OECD, adapted from GOLUB, S. (2003).

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