4

Financial Integration among Developing Countries

Developing countries have become important sources of lending and investment to other developing countries. In years past, most of the capital exported from developing countries found its way to industrial countries, usually to help wealthy individuals safeguard their assets. During the past decade, however, developing countries have become a significant source of foreign direct investment (FDI), bank lending, and even official development assistance (ODA) for other developing countries. This expansion in South–South capital flows reflects developing countries' increasing integration into global financial markets. As developing countries' incomes rise and their banks and firms become increasingly sophisticated, it is natural that they should become more important sources of foreign lending and investment and that a portion of these flows should go to other developing countries. At the same time, South–South capital flows may have implications for developing-country recipients that differ from the implications of capital flows coming from rich countries. The purpose of this chapter is to present data on this growing trend and to evaluate its implications for development. The principal issues are (i) the forces that have propelled South–South financial integration, and (ii) the differences between South–South interactions and financial integration between developing and high-income countries.

The main messages are:

- Capital flows among developing countries increased rapidly over the past 10 years, driven by the technological innovations that support globalization generally, rising incomes in developing countries, and increasingly open policies toward trade and financial markets. South–South financial integration has progressed more rapidly than North–South integration, as South–South trade has expanded more rapidly than North-South trade (capital flows often follow trade) and developing countries have eased constraints on outward investment.
- Developing-country multinationals enjoy some advantages over industrial-country firms when investing in developing countries because of their greater familiarity with technology and business practices suitable for developing-country markets. However, developing-country multinationals also face greater impediments in their home countries than do industrial-country multinationals. Impediments may take the form of bureaucratic constraints on outward investment, other financial constraints, and a paucity of institutional support and business services.
- South–South capital has helped to sustain FDI flows in developing countries even as FDI from industrial countries has declined. It has made more capital available to low-income countries, because developing-country investors are often more willing to handle the special risks encountered in poor countries. In some cases, South–South investment may also confer benefits because firms in receiving countries may find it easier to absorb technology from a developing-country investor than from an industrial-country investor, as developing-country investors are likely to rely on technology appropriate for a developing-country setting.
- Most South–South capital flows occur within the same geographic region, both because they follow trade (and a large share of trade is regional) and because proximity, common

language, and cultural and ethnic ties reduce the risks of lending and investment.

- Developing-country banks are more likely than industrial-country banks to invest in small developing countries with weak institutions. Especially in low-income countries, the performance of foreign banks from developing countries (both in terms of asset quality and efficiency) does not differ from that of foreign banks from rich countries, suggesting that developing-country banks do not pose an additional risk to vulnerable low-income countries because of poor management or weak finances.
- Initiatives to promote the integration of developing countries' stock exchanges have made little progress, and many developing-country capital markets remain more integrated with major international financial markets than with other developing-country markets. Nevertheless, there are recent signs of change, with fewer new issues on U.S. exchanges, in particular, and increased local issuance. Many exchanges may benefit from closer South–South cooperation, including by encouraging cross-border listings and investment, and information/technology sharing.

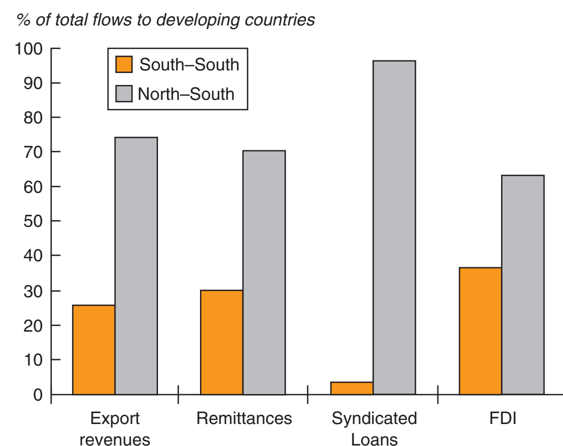
The growth of South–South capital flows

Financial transactions among developing countries increased substantially in the past decade (see annex 1).[1] South–South FDI, for example, increased from $14 billion in 1995 to $47 billion in 2003. The share of South–South flows in total FDI to developing countries rose from 16 percent in 1995 to 36 percent in 2003, a higher share than that of South–South exports in developing countries' total trade and of South–South remittances in their total remittance receipts (figure 4.1).[2] Syndicated loans grew from $0.7 billion in 1985 to $6.2 billion in 2005. The share of South–South flows in total cross-border syndicated lending was 3 percent in 1985, during the Latin American debt crisis, when syndicated loans to Latin America and other major debtors plummeted. That share fell to 1 percent in 1995, with the recovery from the debt crisis, and then rose to 3.4 percent in 2005. By contrast with FDI and bank lending, developing-country stock markets have shown little integration in the form of cross-border listings or establishment of regional stock exchanges.[3]

The growing financial integration of developing countries is driven by the same forces that are increasing integration between developing and high-income countries. Technological advances have reduced the costs of transport and communications, facilitating greater cross-border integration and encouraging the growth of cross-border production networks that involve expanded trade and financial transactions. Income growth has been accompanied by increased sophistication in financial systems, facilitating outward investment. Income growth also is associated with more diverse consumption choices, stimulating international trade. In turn, the rise in international trade has provoked greater cross-border financial transactions. The very large differences in wage levels and capital intensity of production within the developing world also have stimulated South–South flows.

The rise in capital flows among developing countries also reflects the increased importance of developing countries in the global economy. The developing world's share of global GDP rose modestly from about 18 percent in 1990 to 20 percent in 2004, but its share in international trade grew more quickly—from 15 percent in 1991 to 26 percent in 2004. The growing importance of some of the larger developing countries is reflected in their increasingly prominent role in global economic negotiations, particularly within

Figure 4.1 South–South capital flows by type, 2005



Sources: UN Comtrade database; World Bank staff estimates.
Note: Data are for 2005, except for FDI (2003).

the World Trade Organization (WTO). WTO's Ministerial Meeting in Cancun in 2003 showed that coalitions of developing countries (notably the G-20, but also the G-90 group of the poorest countries[4]), if they maintained solidarity, could play a major role in determining the outcome of negotiations on issues of concern to them (Narlikar and Tussie 2004). The emergence of the G-20 has been characterized as moving the WTO from a group dominated by the Quad (Canada, the European Union, Japan, and the United States) to a multipolar environment (Amorim

Box 4.1 Developing countries as aid donors

The Millennium Development Goals call for a global partnership for development. Historically, that partnership has been understood as a matter of North–South cooperation, but that interpretation fails to acknowledge the growing role of developing countries as sources of official development assistance (ODA). In recent years, however, recognition of the importance of South–South cooperation has come from several quarters—among them the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD), the European Union, and the United Nations Development Programme (UNDP).

Brazil, Chile, China, India, South Africa, and Thailand are among the developing countries that now provide aid to others in the developing world. There is evidence that the resources involved in South–South aid initiatives may be increasing. China recently announced an increase in its assistance to developing countries over the next three years, including $10 billion dollars in concessional loans and preferential export credits. In February 2006, Turkey became a member of the OECD Development Centre, demonstrating its commitment to providing development assistance to developing countries.

Developing countries often provide aid through partnerships with traditional donors and international institutions (so-called triangular cooperation). For example, in cooperation with Britain's Department for International Development (DFID) and the U.N. Aids Program, the government of Brazil launched the International Centre for Horizontal Technical Cooperation to fight HIV/AIDS in Latin American countries. The center has allowed Brazil, which already has the region's best record in fighting HIV/AIDS, to strengthen its capacity to provide AIDS-related technical assistance to other Latin American countries.

Data on the magnitude of South-South development assistance are scarce, although initiatives to improve collection are underway.[a] DAC, the South-South Unit of the UNDP, and the World Bank have formed a partnership to collect information about South-South aid and provide a platform for developing countries to share their experiences.

Data from the World Bank Debtor Reporting System indicate that concessional loans from developing countries have shown no clear trend over the past decade, but tend to be dominated by disbursements from just a few countries and show large variability from year to year because of substantial, one-time loans. China accounted for 58 percent of concessional lending from developing countries from 1994 to 2004, and Turkey (due to one disbursement in 1996), the Russian Federation, and Mauritius (due to one disbursement in 2004) for another 30 percent. Fifteen (mostly low-income) countries received some 70 percent of South–South concessional loans during 1994–2004. Sub-Saharan Africa received the greatest amount of South-South concessional loans (47.5 percent), followed by Latin America and the Caribbean (26.5 percent) and Europe and Central Asia (19.1 percent). In 2004 South–South concessional loans made up just 2 percent of all concessional lending to developing countries. Data on grants are not available.

Like other South–South flows, South–South concessional loans are, once we exclude disbursements by China, mostly intraregional (78 percent). Case studies confirm the strong intraregional pattern of South–South development assistance. For example, 90 percent of Thailand's ODA supports infrastructure projects in Cambodia, Laos, Myanmar, and the Maldives (Ministry of Foreign Affairs of Thailand), and 73 percent of India's non-plan grants and loans from 1997–2004 went to neighboring countries (Ministry of Finance of India).

Most emerging donors appear to have a special interest in providing development assistance to African countries. Long a donor in Africa, China, since 2000, has formalized its relationship with the continent through the Forum for China-African Cooperation. Brazilian cooperation with Africa encompasses many areas, including agriculture, infrastructure, trade, and public administration. The country has written off more than $1 billion in debts of African countries. The Russian Federation, too, has written off a substantial amount of African debt, partly under the HIPC initiative. It is studying the possibility of a full HIPC debt write-off for loans not falling under ODA.

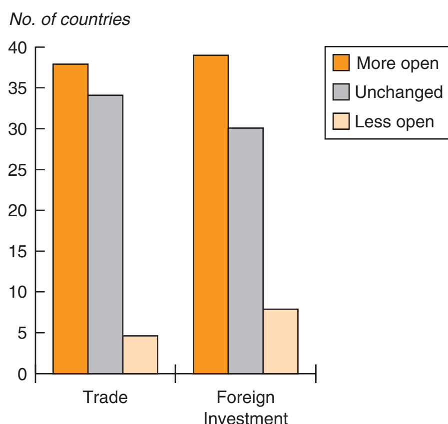
a. DAC provides data on official development assistance for its members and for some non-DAC donors. These include high-income donors, such as Saudi Arabia, where development assistance has accounted for more than 1.3 percent of GDP over the past five years, and some developing-country donors, mostly in Eastern Europe. Since the most prominent emerging donors are not included in the DAC database, however, the numbers do not provide an accurate picture of South–South aid.

2005). More than any previous round of trade negotiations, the Doha Round has been shaped by the actions and positions of developing countries (Zedillo, Messerlin, and Neilson 2005). Another indication of their increasing importance is that a few developing countries have become sources of official development assistance (box 4.1).

South–South financial integration has been given a boost by the rapid opening of developing economies. About half of 77 developing countries rated on a leading index of openness to trade showed some improvement from 1995 to 2005, whereas only 5 showed deterioration (figure 4.2). The rest were unchanged.[5] By contrast, nearly all high-income countries showed no major change in their trade policies over this period, because they already were relatively open economies: the average trade index of high-income economies was more than two points better (on a 1-to-5 scale) than that of developing countries.[6] Moreover, South–South trade expanded more quickly than North–South (box 4.2). Because capital flows often follow trade, this has meant more rapid South–South financial integration as well.

Similarly, a majority of 76 rated developing countries became more open to foreign investment over the past 10 years, while only 8 instituted more restrictive policies. In part this reflects an easing of constraints on outward investment, leading to increased South–South capital flows. The difference between high-income and developing countries is less stark for foreign investment than for trade, as high-income countries in 1995 were only slightly more open than developing countries, and 9 of the 21 rated high-income countries adopted more open regimes over the past 10 years. However, the major sources of outward investment and lending from high-income countries, such as the United States and Germany, already had relatively open regimes in the early 1990s, so their outward capital flows did not receive any further impetus from policies becoming more open.

Figure 4.2 Growing openness of developing countries to trade and capital flows, 1995–2005



Source: Heritage Foundation.
Note: Number of countries rated more open, unchanged, or less open on Heritage Foundation index of openness for period 1995–2005.

Another spur to South–South capital flows has been the rise of regional trade agreements (RTAs) among developing countries. RTAs have mushroomed: since 1990, their number rose from 50 to nearly 230.[7] Activity has been particularly intense in Latin America, Africa, and Asia.

- In Latin America, Mexico and Chile have concluded a series of agreements since the launch of the North American Free Trade Agreement (NAFTA) in 1994.
- In Africa, the countries of eastern and southern Africa established a common market in 1993; the East African Community was formed in the mid-1990s; and the Southern Africa Development Community (SADC) signed a trade cooperation protocol in 1996.
- In Asia since 2000, India has made agreements with the Southern Cone Common Market (MERCOSUR) and Thailand; China has concluded bilateral trade accords with the countries of the Association of Southeast Asian Nations (ASEAN); and the countries of South Asia reached a free trade agreement in 2004.

It is unclear whether such agreements have made a major contribution to South–South trade and capital flows—or simply reflect their increase.

Foreign direct investment in the developing world

South–South FDI is increasing

FDI flows from developing countries to other developing countries increased from an estimated $14 billion in 1995 to $47 billion in 2003 (table 4.1). Increased South–South flows have provided

Box 4.2 South–South FDI and trade

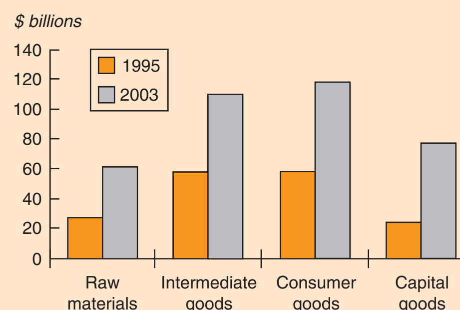
Trade and FDI flows are closely linked (Aizenman and Noy 2005; Albuquerque, Loayza, and Serven 2005; Swenson 2004). At times FDI is a substitute for trade, as when the investment is designed to serve the host market while reducing transport costs or circumventing tariff barriers. However, as trade barriers have come down and the importance of global production networks has risen, FDI and trade have become increasingly complementary (World Bank 2005a). Trade flows also can facilitate FDI by increasing investors' access to information (Portes and Rey 2005).

South–South trade grew rapidly over the past decade, reaching $562 billion in 2004 compared to $222 billion in 1995. From 2000 to 2004, South–South trade grew at an annual rate of 17.6 percent, faster than South–North and North–South exports (12.6 percent and 9.7 percent, respectively). South–South trade made up 26 percent of developing countries' exports in 2004.

Most South–South trade occurs within the same region, although cross-regional trade has also been growing rapidly. In 2004, for example, China was the fourth-largest export destination for Argentina and Brazil. The rapid growth in South–South trade is linked to high growth rates in developing countries, substantial reductions in tariff barriers, and falling transport costs.

The impact of increased investment on South–South trade is hard to measure. However, the surge in trade in raw materials (126 percent from 1995 to 2003) was in line with increasing South–South FDI flows in extractive sectors (see figure). Also, the growth in trade in intermediate goods (91 percent) and capital goods (213 percent) reflects the increased integration of production networks among developing countries, which is stimulated both by North–South and South–South investments.

Composition of South–South exports, 1995 and 2003



Source: UN Comtrade database.

partial compensation for the decline in FDI flows from high-income countries—from $130 billion in 1999 to $82 billion in 2003.

More than 50 developing countries have reported FDI outflows over the past decade, although the data are notoriously understated (World Bank 2004). It is clear that most developing-country FDI comes from the same middle-income countries that account for the lion's share of developing-country economic activity. The 10 countries that accounted for 73 percent of FDI inflows from 2000 to 2004 also were the source of 87 percent of the total outflows (both to developed and developing countries) during the same period.

The expansion of FDI outflows has been driven by developing countries' increasing openness to capital and trade, and by their increasing participation in international production networks. Because of increased globalization of economic activities, developing-country companies face growing competition in sales and in access to resources and strategic assets. As many developing-country governments have eased their policies toward capital outflows, their companies, like industrial-country multinationals, have expanded their operations abroad. South–South FDI flows have also increased in response to the significant rise in South–South trade.

Table 4.1 South–South FDI as a share of global FDI, 1999–2003

$ billions

	1995	1999	2000	2001	2002	2003e
Total inflows (1)	90.3	163.5	154.7	159.3	135.3	129.6
from high-income OECD (2)	48.1	95.4	93.7	84.8	55.1	59.4
from high-income non-OECD (3)	28.2	35.0	22.7	24.8	27.2	22.8
South–South FDI (1)-(2)-(3)	14.0	33.1	38.3	49.7	53.0	47.4
South–South FDI (percent)	*15.5*	*20.2*	*24.8*	*31.2*	*39.2*	*36.6*

Source: World Bank staff estimates.
Note: The South–South estimates are based on 35 countries that account for 85 percent of total FDI flows to developing countries. The estimates are based on the World Bank's classification of developing countries.
e = estimate.

Most South–South FDI goes to countries in the same region

Many expanding developing-country firms tend to invest regionally before taking on the rest of the world because of familiarity gained through trade or ethnic and cultural ties. The regional agreements that began to proliferate in the mid-1990s (World Bank 2005b) also have encouraged intraregional trade and investments. For example, 75 percent of the outward investments of Hungarian firms were within Europe (Elteto and Katalin 2003 and table 4.2); almost 40 percent of Russian firms' investments abroad have been in Europe and Central Asia (Vahtra and Liuhto 2004); and the Russian Federation accounts for one-third of Turkey's recent FDI outflows. Encouraged by cooperation arrangements, ASEAN countries have been the top destination for Thai companies (Mathews 2005). South African investments in other developing countries are largely in the southern part of Africa (Goldstein 2003). Following trade liberalization in Latin America, multinationals from Argentina, Brazil, and Chile expanded their regional operations (Chudnovsky and Lopez 2000).

Nevertheless, some developing-country multinationals are venturing beyond their region. For example, in 2004 about half of China's outward FDI went to natural resources projects in Latin America; Malaysia has emerged as a significant new source of FDI in South Africa (Padayachee and Valodia 1999); and Brazil has considerable investments in Angola and Nigeria (Goldstein 2003).

South–South FDI is concentrated in services and extractive industries

While data on the sectoral composition of South-South FDI are not available, a substantial amount of South-South FDI is known to be in services (infrastructure, in particular) and the extractive industries, as shown by data on mergers and acquisitions (M&A) and privatization transactions (annex 2).

Table 4.2 Regional FDI by multinationals from selected countries

Share of total investment occurring within region

	Regional (South–South)
China	20.7
India	25.4
Hungary	75.1
Thailand	58.8
Turkey	32.0
Russian Fed.	37.0

Source: Goldstein (forthcoming).

South–South FDI in services increased over the last decade, in tandem with the global surge in services sector FDI and the liberalization of the services sector in many developing countries.[8] Developing economies attracted substantial FDI flows from both high-income and other developing countries through the privatization of state-owned assets. Developing-country firms enjoy some advantages in services sector FDI, because services often require proximity between producers and consumers, and often favor cultural and ethnic familiarity.[9] Moreover, developing-country firms can take advantage of their experience in managing the regulatory process (De Sol 2005; Lisitsyn and others 2005) and create regional networks. Nevertheless, FDI from high-income countries is also highly concentrated in the services sector.

The significant rise of South–South FDI in the infrastructure sector, which began in the late 1990s, often was achieved through partnerships between developing- and industrial-country firms. This expansion by northern investors slowed following stock market declines in the industrial countries and in response to problems of corporate governance in some companies and poor regulation in many developing countries. But developing-country firms continued their expansion through buyouts of the assets of their northern partners, privatization and acquisitions deals, and licenses (annex 2).[10] Between 1998 and 2003, developing countries received almost \$160 billion in foreign investment in infrastructure, while developing-country firms invested more than \$30 billion in developing-country infrastructure projects. These data represent commitments for selected projects, and thus the totals cannot be compared to the net-flows data usually shown for FDI (see World Bank 2005a for details). Nevertheless, the commitments data do show that a very significant proportion of FDI flows to developing countries (from both the North and the South) is devoted to infrastructure. South–South flows were greatest in telecommunications and, geographically, in Africa (figure 4.3).

Almost 30 percent of FDI in developing countries' telecommunications during 1998–2003 came from southern telecommunications companies, more than 85 percent of it intraregional. Financial

and equity investors from the South—such as investment banks, private equity funds, and mutual funds—also have become direct investors in the sector, in addition to participating through South–South cross-border lending and syndicated loans, as discussed in detail later in the chapter (World Bank 2006).

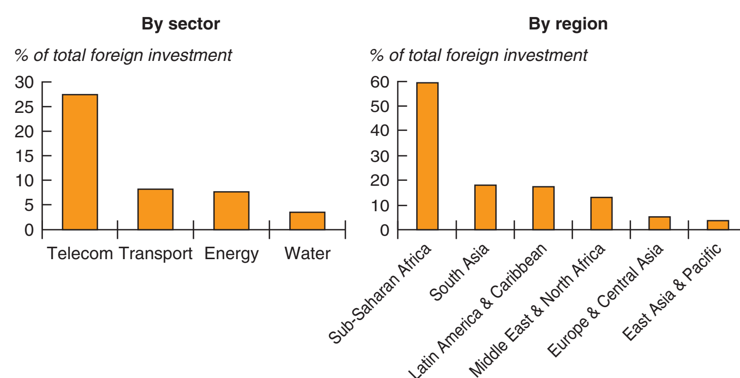
Developing-country multinationals also invest in noninfrastructure services, taking advantage of brand-name recognition, physical proximity, regional distribution networks, taste similarities, and advantages offered by bilateral arrangements. Considerable South–South investment has occurred in banking, as we shall see later in this chapter. Other examples include the growing number of supermarket chains, food companies, pharmaceutical firms, hospitals, and airline carriers from developing countries.[11] In some cases, northern investors undertake investments in developing countries through their subsidiaries in another developing country—for example, Wal-Mex, Wal-Mart's joint venture with a Mexican company.

Developing-country firms (mainly in Asia) have made a small but increasing number of investments in research and development (R&D) in other developing countries (UNCTAD 2005a). China and India are among the largest recipients of R&D-related investments from developing countries, with investment from one another and from Malaysia and Thailand.[12]

The extractive sector (particularly oil and gas) also attracts increasingly large amounts of South–South FDI, mostly through state-owned companies (table 4.3). In recent years, high-growth economies, such as China and India, have acquired oil-and-gas assets or licenses in other developing countries (annex 2). Developing-country companies also are investing in exploration projects. For example, Petronas (Malaysia), which has strong technical competencies in deep-water exploration, has invested in exploration and production projects in more than 20 developing countries (Goldstein forthcoming). Countries that are large oil-and-gas producers, such as República Bolivariana de Venezuela, invest in other developing countries as they integrate their downstream operations such as refining, distribution, and retailing.

South–South FDI in the nonoil mining sector is also increasing. The resource-rich African region has attracted the interest of companies from China, India, South Africa, and other developing countries.[13] Chinese investments in nonoil mining

Figure 4.3 South–South FDI in infrastructure and by region, 1998–2003



Source: World Bank (2005c).

Table 4.3 Selected southern multinationals in the oil-and-gas sector, 2004

Corporation (home country)	Ownership	Total assets in 2004 ($ billions)	Areas of activity
CNPC (China)	State	110.6	Canada, Ecuador, Kazakhstan, Mauritania, Myanmar, Sudan, R. B. de Venezuela
Indian Oil Corp.	State	10.9	Islamic Rep. of Iran, Libya
Lukoil (Russian Federation)	Private	29.8	Iraq, Romania, Ukraine, Bulgaria, Canada, Uzbekistan
PDVSA (R. B. de Venezuela)	State	13.4	Argentina, Belgium, Brazil, Chile, Germany, Paraguay, United States (Citgo)
PEMEX (Mexico)	State	84.1	Argentina
Petrobras (Brazil)	State	19.4	Libya, Mexico, Nigeria, Tanzania
Petro China (China)	State	58.8	Nigeria, Sudan, R. B. de Venezuela
Petronas (Malaysia)	State	53.5	Cambodia, Chad, Islamic Rep. of Iran, Myanmar, Sudan, Turkmenistan
Saudi Aramco (Saudi Arabia)	State		Canada, China, United States

Sources: UNCTAD, ECLAC, and *Oil & Gas Journal* Special Report 2001, company annual reports, company Web sites.

projects have been growing in Latin America, and several Russian companies have investments in Central Asia and the Middle East (Vahtra and Liuhto 2004).[14]

Recent bilateral and regional initiatives among developing countries are centered on cooperation in resource-seeking projects, including a proposal to create a regional state-owned energy company in Latin America; joint-venture projects involving India, Bangladesh, Myanmar, and Thailand; China's agreements with Argentina and Brazil to cooperate in mining, oil, and infrastructure projects (UNCTAD 2005b); and partnerships between China and India for the acquisition of energy assets.

Manufacturing also receives considerable South–South FDI flows, although projects tend to be smaller than the large privatization and M&A deals in services and the extractive industries. Developing-country multinationals have invested in efficiency-seeking activities abroad following erosion in their competitiveness, at home and in export markets, because of currency appreciation, increased labor costs, or other causes (Mirza 2000). In many middle-income countries, higher living standards are reflected in increased labor costs.[15] Developing-country manufacturing firms also invest abroad to sell into the target markets or to access other markets, sometimes through special arrangements. Examples include the investments in India and Thailand of Chinese white goods producer Haier, and the plants in China, Egypt, India, and Ethiopia of Russian automobile manufacturer UralAZ plants (Vahtra and Liuhto 2004). Special arrangements play an important role in attracting South–South FDI to low-income countries. Chinese, Indian, Malaysian, and Sri Lankan textile companies have investments in Africa to export garments to U.S. and European markets through free trade agreements. Some developing-country firms are investing in the manufacture of generic drugs in Africa because WTO provides that patents may be broken in cases of national emergency. A few Indian and Chinese companies are introducing anti-malarial and AIDS drugs under such arrangements (Goldstein and others 2006).[16]

In some cases, FDI from high-income countries has facilitated South–South flows in the manufacturing sector. For example, Mexican Bimbo, a food producer, has invested abroad since becoming McDonalds' exclusive supplier in Latin America and more recently in Europe.

State-owned and small and medium enterprises are investing abroad

State-owned enterprises (SOE) in extractive industries and infrastructure are a considerable source of South–South FDI flows.[17] The role of SOEs in overseas investments is significant in China, where 43 percent of outward FDI stock in 2003 was held by SOEs (Giroud 2005). This indicates that a considerable portion of South–South FDI may be driven not only by economic but also by political and strategic factors.[18] SOEs usually have an advantage over privately owned firms, since they enjoy better financing terms when funded by state-owned banks. In some cases, governments negotiate packages of investment deals that may give additional bargaining power to SOEs.[19]

Small and medium enterprises (SMEs) also provide a significant amount of investment in other developing countries.[20] In India, for example, SMEs accounted for 26 percent of overseas projects (6.7 percent of the value) in manufacturing and 41.1 percent (47.1 percent of the value) in the software industry (Pradhan 2005). Almost three-fourths of companies investing abroad in Poland and Estonia, and about one-third in the Czech Republic and in Hungary, are SMEs (Sevtlicic and Rojec 2003).

Southern multinationals are supported by government incentives

In addition to easing restrictions on capital outflows, some developing-country governments have provided fiscal and other incentives for outward investment, particularly South–South FDI. China's Export-Import Bank, for example, provides loans for investments in resource development and infrastructure, as well as for projects that facilitate trade. If the investment is in an aid-receiving country, firms can receive preferential loans under Chinese aid programs or projects (UNCTAD 2005b). Malaysia supports special deals for FDI outflows to countries such as India, the Philippines, Tanzania, and Vietnam (Mirza 2000). The Thai government promotes Thai firms' involvement in infrastructure projects in selected developing countries in the region (UNCTAD 2005b).

Some regional arrangements, such as SADC, ASEAN, MERCOSUR, and the Andean Community offer various incentives for outward investment within the region, including lower tax and tariff rates and easier profit repatriation. Some

members of the regions maintain bilateral investment agreements and double-taxation treaties.

Whether these incentives encourage or direct FDI outflows, and at what fiscal cost, is unclear. UNCTAD (1998) found that incentives had a positive, but minimal, effect. On the other hand, Hallward-Dreimeier (2003), using only OECD countries, and Tobin and Rose-Ackerman (2005), using a larger sample of countries, found that incentives can further increase FDI flows in countries only where the environment for FDI is already strong. Banga (2003) shows that India's fiscal incentives and lower tariff rates attracted investors from developing countries only; the removal of restrictions was necessary to attract investments from developed countries. Interviews with Malaysian investors suggest that tax and fiscal incentives were not important (UNCTAD 2005a). In some cases, incentives simply generate so-called round-tripping (capital outflows to finance investment back in the home country). For example, India's advantageous tax treaty with Mauritius encourages many Indian investors to incorporate in Mauritius in order to benefit from this tax treatment (Shah and Patnaik 2005).

Developing-country multinationals may enjoy some advantages over industrial-country firms when investing in developing countries

Compared to their northern counterparts, developing-country multinationals may enjoy some advantages when investing in developing countries. Companies with a significant regional presence often benefit from well-established distribution networks. Because of their experience in their home markets, they are often in a position to use locally available inputs more efficiently. And some developing-country firms are more familiar than northern firms with lower-cost production processes that are appropriate for developing-country markets. For example, India's Tata Group produces a car that is significantly less expensive than those of the major automobile companies.[21] While the car lacks some of the qualities desired by industrial-country consumers, it has found a ready market in India and several other developing countries. Finally, developing-country firms may also use technologies that are better suited to conditions in developing countries. For example, in Vietnam, TVs made by China's TCL are the most popular brand, as their powerful color TV receivers provide clear reception even in remote areas (Yi 2004).

Geographical proximity and cultural similarities can make coordination of foreign operations more effective (IMF–World Bank 2005; UNCTAD 2005b). Developing-country firms may have a comparative advantage over companies from developed countries in doing business in challenging economic and political conditions because of their experience in their home economies (Claessens and Van Horen 2006). This sort of advantage brought higher rates of return for northern investors that partnered with Chilean companies to invest in Latin America than for those that invested alone (De Sol 2005). The relative success in Uganda of MTN (the South African telecommunications company), compared with its competitors from developed countries, was traceable to its in-house expertise in managing pertinent economic and political risks (Goldstein 2003).

Developing-country firms may also be more willing to assume the risks of postconflict and other politically difficult situations (Sull and Escobari 2004). For example, Chinese companies (not all of them SOEs) are the only foreigners that have invested in Sierra Leone since the end of the civil war. Egypt's Orascam is the only foreign telecom company operating in Iraq (EIU 2005).

Institutional, financial, and operational impediments constrain FDI from developing countries

Despite these advantages, developing-country firms face institutional procedures, financial restrictions, and operational problems in their home countries that can make it difficult for them to invest abroad.

Institutional procedures. Many developing countries still have various levels of capital controls, and firms may be subject to regulatory burdens to obtain access to foreign exchange. For example, in addition to several capital-control procedures, China's regulations require its multinationals (state-owned or private) to submit a certificate of establishment of the firm in China, contracts and agreements relating to the overseas project, various elements of a project feasibility study, assessments of the project made by the Chinese embassy in the host country, and audited financial reports and bank statements—all before proceeding with an overseas investment (FIAS 2005). Such requirements have increased costs and in some cases prevented SMEs from investing

abroad, while some larger firms have used offshore platforms for their foreign investments. For example, many Chinese companies use their Hong Kong affiliates as a base from which to expand overseas (UNCTAD 2003).

Developing countries often lack the institutional infrastructure needed to provide foreign investors with the support services that their counterparts in developed countries take for granted. Access to knowledgeable consulting firms, business associations, banks, and other sources of information about overseas markets and practices is more difficult to obtain in most parts of the developing world. Unlike in developed economies, services that promote outward investment are nonexistent or in their infancy in most developing countries. These handicaps have affected the development and operations of overseas projects, particularly for companies relatively new to outward FDI.

Financial restrictions. Developing-country firms, particularly SMEs, face more severe financial constraints than do their industrial-country counterparts, because local financial markets are less developed. And access to international financial markets is limited and costly for many of these firms, since they carry the sovereign risk of the home country in addition to their company risks (IMF–World Bank 2005). These challenges sometimes lead large and successful developing-country multinationals to migrate to industrial countries. For example, South African Brewery moved its headquarters to Britain in 2001 to improve its risk rating and position itself for global expansion. India's Ispat Corporation moved to the Netherlands for similar reasons.

Operational challenges. Developing-country firms that invest abroad face operational issues that vary with the firm's level of experience as a foreign investor and to some extent with the business environment in the firm's home country. For example, with limited experience in FDI, some Chinese investors find it difficult to formulate projects that fit in with the culture, market characteristics, and regulatory environment of foreign countries (FIAS 2005). Some developing-country multinationals may have overbid for large assets due to lack of experience (IMF–World Bank 2005; *Financial Times* 2004). This is not an unusual phenomenon: Japanese firms experienced similar challenges when they started to venture abroad in the late 1980s (Goldstein forthcoming). The World Bank Group has made efforts to assist developing-country multinationals in overcoming the institutional, financial, and operational challenges they face (box 4.3).

South–South FDI may generate important benefits for developing countries

The emergence of the South as a substantial source of FDI for developing countries may have significant implications for economic development. First, South–South FDI represents an opportunity for low-income countries. Except in the extractive sector, most northern multinationals are unlikely to invest in small markets, as market size is a major determinant of North–South FDI (Levy-Yeyati, Ugo, and Stein 2002; Stein and Daude 2001). In contrast, southern multinationals tend to invest in neighboring developing countries with a similar or lower level of development than their home country (World Bank 2005a). South–South FDI flows, however small, are significant for many poor countries, particularly those that are close to major investors. For example, India (in hotels and

Box 4.3 The World Bank Group and South–South flows

The World Bank Group, particularly the International Finance Corporation, has several programs to help developing-country multinationals. IFC's Foreign Investment Advisory Service (FIAS) is surveying firms and assessing the need for technical assistance to governments to enhance the investment climate as it affects outward FDI. The Multilateral Investment Guarantee Agency (MIGA) supports the efforts of local export-credit agencies to serve emerging South-South investors through coinsurance and reinsurance arrangements. In addition, MIGA's recently launched Small Investment Program—which offers a streamlined insurance package and underwriting process—is designed to increase South-South investment.

manufacturing) and China (in manufacturing) account for more than half of FDI in Nepal. Most FDI in Mongolia comes from China and the Russian Federation. An Indian company is securing approval for a $2.5 billion investment project in Bangladesh, which will be the largest foreign investment in the country. Moreover, low-income countries receive almost one-third of their banking sector FDI from other developing countries (see the section on banking in this chapter).

Second, in some cases, developing countries may see greater positive spillovers from FDI originating in developing countries than from investments originating in industrial countries.[22] To the extent that developing-country firms provide technologies that are more suitable for other developing countries (compared with more sophisticated technologies used by industrial-country firms), developing countries may be in a better position to absorb them. Baldwin and Winters (2004) find that a country's absorption capacity is greater with a smaller technological gap between the foreign firm and domestic firms. Kabelwa (2004) finds that narrower technological gaps between developing-country multinationals and host economies, compared with their industrial-country counterparts, foster positive spillovers. Schiff and others (2002) found that the extent of spillovers from participation in trade (as opposed to FDI) depends on the sector: companies in low R&D-intensive industries benefit more from trading with other developing-country firms than with firms from industrial countries, while companies in high R&D industries benefit more from trading with firms from industrial countries. However, the importance of this advantage, which is most significant in manufacturing, is unclear, as South-South FDI is heavily concentrated in extractive industries and infrastructure, where such spillovers are limited.

South–South FDI is not always more beneficial than North–South FDI. Over the years, many northern multinationals have participated in initiatives to improve the transparency of their foreign operations, as well as the environmental and labor standards observed in those operations.[23] Such initiatives are less likely to have been implemented by southern companies, which also may have low environmental and labor standards (Goldstein forthcoming; IMF–World Bank 2005). That said, compliance with corporate governance standards by developing countries is increasing, although significant regional and sectoral variations in compliance remain (OECD 2005b). Ultimately, of course, it is the host country's responsibility to improve its business environment and regulatory system to realize the development potential of FDI.

Outward investment (including to high-income countries) may also generate benefits to the investing economy through increased competitiveness and exports. Surveys report that direct presence in foreign markets has enabled many Southern firms to increase their competitiveness and to respond better to consumer demand.[24] Geographic risk diversification and market access can be crucial for some southern firms that are faced with volatile home markets.

South–South banking

Traditionally, banks have followed their clients overseas. Thus the growing importance of developing-country firms in overseas trade and investment has led to an expansion of cross-border activities by developing-country banks, both through lending and through investment carried out by branches and subsidiaries. As is the case with other financial flows to developing countries, foreign bank lending is dominated by industrial-country banks. However, developing-country banks are playing a growing and already important role, especially in low-income countries. Because they are willing to penetrate markets where banks from industrial countries are reluctant to go, these banks may provide an important new source of external finance for low-income countries.

The rise in South–South cross-border banking is driven by several factors

The recent increase in banks' cross-border activities has come in response to global economic trends, liberalization of the financial sector in many developing countries, and advances in technology.

Economic trends. The general expansion of syndicated lending to developing countries and the growing importance of developing-country lenders in such lending reflect a favorable external financing environment characterized by ample global liquidity, as well as improved economic conditions and greater openness to trade and capital flows in

many developing countries. As South–South trade and FDI have expanded, many banks have followed their clients. FDI in banking is correlated with bilateral trade and FDI between source and host countries (Grosse and Goldberg 1991; Brealey and Kaplanis 1996; Williams 1998; Yamori 1998). Preferential trade agreements, which have burgeoned in number and scope since the 1990s (WTO 2003), are opening new opportunities for banks to provide trade finance. For example, Banco de Chile, the country's second-largest bank in terms of assets, recently opened a branch in Beijing—reportedly to position itself to benefit from a new free-trade accord between the two countries (*Latin Finance* 2005). A number of Central American banks (e.g., Panama's Banistmo, El Salvador's Banco Cuscatlan) are seeking growth opportunities in other Central American retail financial markets to capitalize on regional trade integration and the recently concluded Central American Free Trade Agreement (CAFTA). Standard Bank of South Africa has established a sizable presence in southern and eastern Africa, reflecting South Africa's increased investment in and trade with the region.

Migration. Banks have expanded cross-border activities to serve growing numbers of expatriates. For example, Pakistan's Habib Bank has targeted a well-established customer base of expatriates through its branch network in South Asia.

Financial sector liberalization. The liberalization of developing countries' banking sectors and the sale of state-owned banks have increased opportunities for cross-border lending and investment by developing-country banks. Rules governing cross-border lending and the establishment of branches and subsidiaries by foreign banks have been eased—in many cases under the impetus of WTO commitments, notably in the Asia-Pacific region (Capital Intelligence and EIU, various issues).

Technology. Advances in telecommunications and information technology are enabling banks and other financial institutions—including those based in developing countries—to better manage cross-border activities. Banks based in Asia-Pacific, the Middle East, and elsewhere have been investing heavily in electronic delivery systems and other technologies to enhance their ability to offer a wider array of financial services at a distance from headquarters.[25] Sri Lanka's Commercial Bank of Ceylon and Hungary's OTP Bank, among others, have boosted their investment in technology to support a strategy of greater focus on serving SMEs and retail credit clients.

The several motives behind the expansion of South–South banking can be illustrated by the experience of the State Bank of India (SBI) and ICICI Bank, India's largest privately owned bank. Both are undertaking overseas expansions in Asia, Africa, and the Middle East to tap retail credit clients, to facilitate increasing trade and investment flows between India and other countries, to provide foreign currency–denominated loans to the overseas affiliates of Indian companies, and to provide remittance and retail credit services for Indian expatriates (Capital Intelligence, various issues; State Bank of India 2005; and ICICI Bank 2005).

South–South bank lending has grown

There are two sources of data on developing countries' foreign bank lending (see annex 1 for data sources and definitions). The Bank for International Settlements (BIS) in Basel publishes data on the foreign lending of banks from a few developing countries. Dealogic Loanware reports data on syndicated loan transactions, which are loans arranged by a group of banks (referred to as a syndicate).

Syndicated lending. Most syndicated loans to developing countries are made by groups of banks in high-income countries. In the past 20 years, however, the volume of syndicated lending from developing countries and the number of banks participating in syndicates have grown sharply. South–South syndicated flows are estimated to have increased from $0.7 billion in 1985 to $6.2 billion in 2005, although the data have shown substantial variability across years and countries.[26] The number of developing countries receiving such flows also has grown, from 19 in 1985 to 41 in 2005.[27]

The rise in South–South syndicated lending partly reflects the overall rise in syndicated lending to developing countries from all sources, which increased by almost the same amount from 1985 to 2005. Indeed, the share of South–South lending in total developing-country borrowing from the syndicated loan market equaled 3 percent in 1985 during the debt crisis. However, once lending from industrial countries picked up, the share of South–South lending fell to 1 percent in 1995, but then rose to 3.4 percent in 2005 (table 4.4). Borrowers in Europe and Central Asia and the Middle East and North Africa sourced the largest portion

Table 4.4 South–South cross-border syndicated lending, 1985–2005

$ millions

Borrower's region of domicile	1985	1995	2004	2005
Eastern Europe & Central Asia	234.4	31.2	1,420.0	2,719.7
Middle East & North Africa	326.8	109.1	694.2	1,120.9
Sub-Saharan Africa	8.7	130.0	986.8	364.0
South Asia	15.0	12.9	349.7	463.8
East Asia & Pacific	56.4	431.6	470.5	872.0
Latin America & Caribbean	54.2	165.1	301.7	686.1
Total	695.5	879.9	4,222.9	6,226.5
Total syndicated lending to developing-country borrowers	22,895.6	91,943.2	112,238.2	184,034.7
South–South share in syndicated lending to developing countries	3.0	1.0	3.8	3.4

Source: World Bank staff estimates based on loan syndicate transactions reported in Dealogic Loanware dataset.

of their syndicated loans from nonlocal developing-country banks (4.2 percent overall for both regions), while borrowers in Latin America continued to source the smallest portion (about 1.8 percent overall).

The growing participation of developing-country banks in syndicated lending also reflects the increasing size and sophistication of those banks. As syndicates typically are unwilling to include banks that are relatively unknown or unreliable, the growing role of developing-country banks in syndicates is one indication of their arrival as major players in global finance. For many banks, participation in recent South–South syndicated loans has been one element in a strategy of expansion into other developing countries through loans, acquisitions, and greenfield investments.[28]

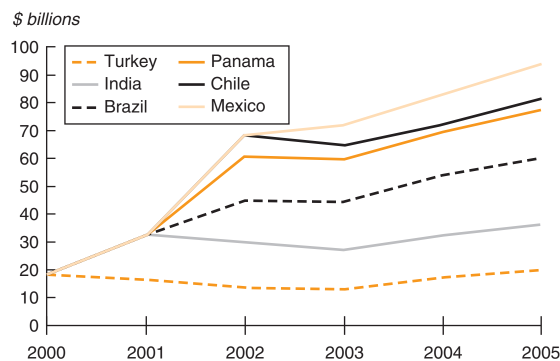
Despite the growth of South–South lending, some aspects of developing countries' participation have changed little over the years. Participation by local banks in syndicated loan transactions remains strong.[29] Also, banks domiciled in developing countries tend not to be the lead arrangers or major participants in a syndicate, given their relative capital constraints compared with major industrial-country banks. Nevertheless, nonlocal developing-country banks participated in a mandated lead arranger role in nearly one-quarter of all South–South cross-border syndicated loan transactions in 2005 (49 of 206 transactions).[30] South Africa's Standard Bank was particularly active, as a mandated lead arranger for 28 transactions in 2005.

The regional distribution of South–South syndicated lending flows as compared with syndicated lending flows to developing countries from all sources was broadly similar last year. Borrowers in Eastern Europe and Central Asia attracted the highest share from both source groupings (35 percent and 44 percent, respectively), while borrowers in Sub-Saharan Africa attracted the lowest share (6 percent) from both source groupings. Notably, East Asia and Pacific attracted a much smaller share in 2005 from both source groupings (14 percent and 17 percent, respectively) compared with a decade earlier, just a few years ahead of the financial crisis. In 1995, East Asia and Pacific received nearly half of syndicated lending flows destined for developing countries—sourced both on a cross-border South–South basis and from all lending sources worldwide The share of Eastern Europe and Central Asia, in particular, was significantly smaller (at just 4 percent and 7 percent, respectively).

Cross-border lending reported to the Bank for International Settlements (BIS). Cross-border lending by banks located in developing countries that report to the BIS (that is, countries with significant cross-border lending) has increased significantly, reaching $94 billion in 2005 (figure 4.4).[31] While in 1999 no developing country reported to the BIS, by 2005 six developing countries (Brazil, Chile, India, Mexico, Panama, and Turkey) were reporting data; more are expected to follow soon. About 85 percent of the cross-border lending was to the banking sector (the average across all countries was 65 percent), indicating that a substantial share of this lending represents international transactions between affiliates of the same bank.

The above data indicate the growing importance of certain developing countries as banking centers from which domestic and foreign banks operate, but they capture external positions in all countries (including high-income countries). Data

Figure 4.4 Cross-border lending to all countries by banks in developing countries, 2000–5



Source: Bank for International Settlements.
Note: Yearly data are averages based on quarterly data.

from countries that report the destination of their foreign claims (so far only Brazil, Chile, Mexico, and Panama) indicate that the South–South component is growing.[32] For example, foreign claims on developing countries reported by Brazilian banks rose from $1 billion in the fourth quarter of 2002 to $2 billion in the third quarter of 2003, while Chilean banks' foreign claims on developing countries rose from $176 million to $891 million in the same period. The increase in South–South foreign claims by banks from Panama rose only by 10 percent, and foreign claims on developing countries by Mexican banks decreased in the last two years. However, on average the increase of South–South foreign claims reported by these four countries has been more significant than the 58 percent rise in total North–South foreign claims (from all high-income to all developing countries).

South–South bank ownership is significant

Banks from 40 developing countries (most of them middle-income) hold 5 percent of the $944 billion dollars in foreign bank assets in developing countries (based on Bankscope data; see annex 1).[33] Excluding Panama (an important offshore center), the biggest investors are banks in South Africa, Malaysia, and Hungary. The pattern of ownership differs significantly by region. In South Asia, 20 percent of foreign bank assets are held by banks in other developing countries.[34] In Europe and Central Asia the same share is just 2 percent (table 4.5).[35] While these data indicate that participation by developing-country banks is significant, banks from high-income countries still account for 95 percent of total foreign bank assets in developing countries. Moreover, all foreign banks account for only 16 percent of total banking sector assets in developing countries. South–South bank ownership thus accounts for less than 1 percent of total bank assets in developing countries. Northern foreign banks in developing countries—with median assets of $361 million—tend to be larger than southern foreign banks—with median assets of $92 million. Southern bank participation is more important in terms of the number of banks.

South–South banking increases opportunities for low-income countries

Banks from industrialized countries and developing countries alike tend to invest in countries with which they have strong trade linkages, that share a common language and legal system, and that are nearby. But because developing-country banks have more experience doing business in a challeng-

Table 4.5 Source of foreign bank assets, by region
% of foreign bank assets in host region owned by banks in other regions

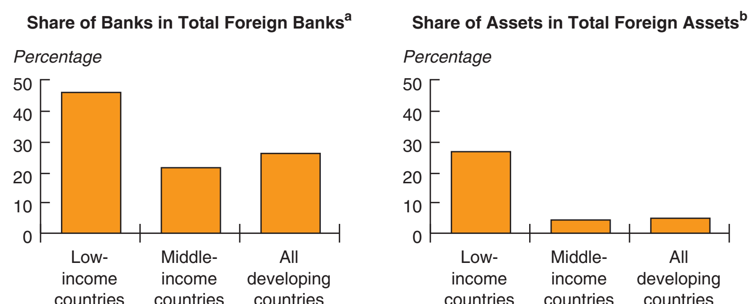
	Source region							
Host region	East Asia & Pacific	Europe & Central Asia	Latin America & Caribbean	Middle East & North Africa	South Asia	Sub-Saharan Africa	High-income countries	Total
East Asia & Pacific	6.39	..	..	..	..	..	93.57	100
Europe & Central Asia	..	1.84	..	0.01	..	0.03	98.11	100
Latin America & Caribbean	..	..	4.78	..	..	..	95.26	100
Middle East & North Africa	..	..	..	8.91	..	..	91.19	100
South Asia	..	..	..	..	0.74	19.51	79.83	100
Sub-Saharan Africa	0.07	0.03	0.02	0.29	1.99	14.12	83.54	100

Source: World Bank Staff estimates based on Bankscope.
Note: Foreign assets are averages over the 2000–4 period. A foreign bank is defined to have at least 50 percent foreign ownership as of December 2005.
.. = Negligible.

ing economic environment, they have a comparative advantage over industrialized-country banks when entering low-income countries (box 4.4). As a result, low-income countries, which have problems attracting bank lending from industrial country banks, are benefiting disproportionately from the increased supply of banking services from other developing countries.

Cross-border investment by developing-country banks is more significant in low-income countries (27 percent of foreign bank assets and 47 percent of the number of foreign banks) than in middle-income countries (4 percent of foreign assets and 22 percent of foreign banks) (figure 4.5). The correlation between income level and the share of banks from developing countries in foreign bank assets is –0.37, which is statistically significant. In addition, low-income countries are also important in South–South syndicated lending; their share increased from 3 percent ($24 million) in 1985 to 17 percent ($1 billion) in 2005, although the vast majority of this latter amount was concentrated in a few countries in East and South Asia (notably, India).

Figure 4.5 South–South foreign bank entry in developing countries, by country income level



Source: World Bank Staff estimates based on Bankscope.
Note: "Southern foreign banks" are those banks headquartered in a developing country. A foreign bank is one that had at least 50 percent foreign ownership as of December 2005.
a. Number of southern foreign banks as a percentage of all foreign banks (left panel).
b. Bank assets held by southern foreign banks as a percentage of total foreign assets, averaged over 2000–4 (right panel).

South–South banking takes place largely within the region

Foreign investment and lending by developing-country banks is regionally concentrated. In East Asia and the Pacific, Europe and Central Asia, and the Middle East and North Africa, practically all developing-country foreign banks are from the same region (table 4.5). In Sub-Saharan Africa, banks from other regions account for only 14 percent of developing-country foreign banks. By contrast, almost all developing-country foreign banks in South Asia are from Sub-Saharan Africa. However, these data reflect ownership by branches and holding companies of banks from OECD countries based in Mauritius (an offshore banking center) that own Indian banks.

Intraregional transactions are becoming less dominant in South–South cross-border syndicated lending. In 2005, 52 percent of this lending was to borrowers in the same region as the lenders, down from 66 percent in 1985.[36] Intraregional lending remained particularly important in East Asia (where 97 percent of South–South cross-border loans are intraregional) and Latin America (83 percent) in 2005. Cross-regional South–South lending was particularly important in India (where 76 percent of South–South lending was cross-regional), Kazakhstan (83 percent), and the Russian Federation (77 percent). Important motivations for cross-regional South–South bank lending include trade financing (which accounted for the vast majority of cross-regional loans in 2005) and the desire to serve expatriates. In addition to these purposes, major uses of intraregional loans were the financing of acquisitions and other expansion plans (particularly in East Asia) and infrastructural development projects in power, telecommunications, and transport (in both East Asia and Latin America).

The dominance of intraregional cross-border banking in part reflects the importance of intraregional trade and FDI flows (discussed earlier) and the priority being given to regional cooperation and integration in policy agendas. In addition, geographic proximity often implies a common cultural heritage, language, or ethnic ties, making it easier for banks to assume more risk.

Just as local banks have an advantage over foreign banks due to their greater knowledge of local conditions and their ability to screen and monitor local borrowers (Nini 2004), foreign banks from within the same geographic region may have an advantage over other nonlocal lenders. This greater familiarity means that banks from the same region can lend more than nonregional banks and are more likely to expand beyond the traditional focus on corporate banking

Box 4.4 Determinants of South–South foreign bank entry

The economic literature on the determinants of foreign bank entry has not distinguished between foreign ownership by banks from industrial countries and developing countries. (see, for example, Buch and DeLong 2004; Focarelli and Pozzolo 2000; and Galindo, Micco, and Serra 2003). However, country studies and anecdotal evidence suggest that industrial-country banks invest in developing countries for different reasons than do developing-country banks. To address this issue, we estimated a model of decisions by foreign banks to enter developing-country markets. We measure foreign bank penetration, the dependent variable, in terms of the level of total assets owned by foreigners. The model is explained in detail in annex 3.

The results (see table) reveal some important similarities and differences between the determinants of foreign bank investment in developing countries by industrial-country and developing-country banks:

- FDI by both industrial-country and developing-country banks is strongly related to bilateral trade flows, one indicator of integration between source and host countries. Essentially, banks tend to follow their customers.
- Colonial ties are an important explanation of foreign bank penetration by industrial-country banks, but less so for developing-country banks.
- A common language, which reduces the cost of foreign banking, is a significant determinant of foreign bank entry for both industrial- and developing-country banks.
- Distance is negatively related to foreign bank entry, but the effect appears to be smaller for banks from developing countries than for banks from industrial countries.
- After controlling for distance, a common border is not a significant determinant of foreign bank entry.
- Banks from industrial countries tend to go to large developing countries, while banks from developing countries tend to enter the smaller developing countries. In addition, the depth of the financial sector is negatively correlated with foreign ownership by industrial-country banks, but positively with ownership by developing-country banks
- Banks from industrial and developing countries are equally likely to be deterred from entering a developing country with a different legal system.

Determinants of foreign bank entry: northern versus southern foreign banks

	Northern bank	Southern bank
Colonial linkages	0.757*	0.699*
Border	0.297	0.297
Common language	0.338*	0.338*
Distance	–0.153*	–0.123*
Trade	0.014*	0.014*
GDP	0.040*	–0.009*
Financial sector depth	–0.048*	0.008*
Different legal system	–0.045*	–0.045*
Quality institutions	0.006	–0.060*
Observations	5,532	

Source: World Bank staff calculations.
Note: Mean of dependent variable = 0.59
* = significant at level of at least 10 percent.

- After controlling for all of the above determinants of FDI, the quality of institutions does not appear to influence the decision by an industrial-country bank to enter a developing country. However, banks from developing countries are more likely to enter developing countries with weak institutions. This result seems to indicate that banks from developing countries, being more familiar with working in domestic environments where institutional development is low, are more suited to investing in such markets.

The coefficients in the table express the marginal effects of the impact of the respective variable on foreign ownership by northern and southern banks. The marginal effects capture the combined effect of the impact of the explanatory variable on the probability of entering the host country and on the amount of FDI.

Overall, the model provides support for the conclusions in the literature that FDI in foreign banking is strongly related to economic integration, common language, and proximity; this holds true for both industrial and developing-country banks. More interestingly, it appears that developing-country banks are more likely to invest in small developing countries with weak institutions, where industrial country banks are reluctant to go. These results indicate that FDI decisions are not so much influenced by the absolute amount of risk faced by firms, but rather by a given firm's ability to bear that risk better than other investors.

For a more detailed discussion, see Van Horen (2006).

to sectors that require new and different sources of information. For example, in some developing countries, foreign banks from the same region have given more emphasis to providing retail financial services (mortgages, consumer loans, debt and credit card services, and remittance services for expatriates) and loans to SMEs.[37]

Developing-country banks are not a significantly greater source of poor asset quality or management

Investments in the banking sector of developing countries by banks from other developing countries could create instability if those banks were poorly managed or if their asset quality were low. As with industrial-country banks, however, the record of entry into developing-country financial systems by banks from other developing countries is mixed. For example, Ecobank, a successful private sector banking group based in 13 countries in West and Central Africa, has strengthened the banks it has taken over. Standbic, a South African bank, greatly improved the soundness and efficiency of the United Commercial Bank of Uganda.[38] By contrast, several branches of the Meridian Bank of Zambia were liquidated after a major run on its deposits (Rakner, van de Walle, and Mulaisho 1999). The directors of the bank were prosecuted for criminal charges for allegedly having received deposits while knowing that the bank was insolvent.[39]

The available data, however, do not indicate that, on average, developing-country banks investing in low-income developing countries are significantly weaker than industrial-country banks that do the same. The asset quality of developing-country banks in these countries is lower than that of banks from high-income countries, but the differences are not statistically significant (table 4.6). Similarly, indicators of efficiency and operational performance in low-income countries are slightly better for northern banks, but not by enough to be statistically significant. In middle-income countries there is some indication that banks from high-income countries seem to outperform developing-country banks, both in asset quality and in efficiency and operational performance. However, since penetration of the banking sector by developing-country banks is especially prevalent in low-income countries, the risks posed by southern foreign banks to their host countries because of possible poor capitalization or management are not significantly greater than similar risks posed by northern banks.

Table 4.6 Performance indicators for northern and southern foreign banks, selected aggregates, 2000–4
Ratios in percentages

		Asset quality		Efficiency and operational performance				Memo
		Loan loss reserves/ gross loans	Loan loss provision/net interest revenue	Net interest margin	Return on average assets	Cost-to-income ratio	Net income/ total assets	No. of countries (banks)
Low-income countries	North foreign	7.05	15.54	9.47	1.88	65.80	1.77	30 (74)
	South foreign	6.92	26.11	8.94	0.84	90.90	0.77	30 (63)
Middle-income countries	North foreign	**6.42**	27.03	6.38	**1.14**	73.73	0.81	53 (439)
	South foreign	**11.38**	49.12	7.82	**–0.35**	76.04	0.17	53 (87)
All countries	North foreign	**6.50**	25.43	6.86	**1.25**	72.64	0.94	83 (513)
	South foreign	**9.46**	39.54	8.30	**0.16**	82.26	0.42	83 (150)

Source: World Bank staff estimates based on Bankscope.
Note: Ratios are calculated for each bank in each country and then averaged for North and South foreign banks separately within an income level. Host and source countries that are offshore banking centers are excluded from the sample.
Pairs of entries that are significantly different from each other at the 10% level of significance are shown in bold.
The ratio of loan-loss reserves to gross loans indicates how much of the total portfolio has been provided for but not charged off. Given a similar charge-off policy, the higher the ratio, the poorer the quality of the loan portfolio. Loan-loss provision over net interest revenue is the relationship between provisions in the profit-and-loss account and interest income over the same period. This ratio should be as low as possible. Net interest margin is the ratio of net interest income to earning assets. The higher this figure, the cheaper the funding or the higher the margin the bank is commanding. Higher margins are desirable as long as asset quality is maintained. Return on average assets looks at the returns generated from the assets financed by the bank. The cost-to-income ratio measures the overheads and costs of running the bank as percentage of income generated before provisions. It is a measure of efficiency, although if the lending margins in a particular country are very high then the ratio will improve as a result. Net income to total assets shows the profitability of the bank.

South–South banking can strengthen domestic financial services but may entail some risks

Even if foreign bank entry does not generate a capital inflow (because subsidiaries may generate their funds locally), it can improve the quality and availability of domestic financial services. Increased competitive pressure can lead to stronger credit growth, more aggressive provisioning behavior, and higher loss-absorption capacity—all of which can help stabilize domestic banking systems (Crystal, Dages, and Goldberg 2001). Managerial and technology spillovers may benefit domestic banks, as well. Foreign banks also can help stimulate the development of the underlying supervisory and legal system by pressuring host-country governments to improve institutions, thereby enhancing the country's access to the international capital market (see, for example, Levine 1996). Claessens, Demirguc-Kunt, and Huizinga (2001) find that greater presence of foreign banks (from high-income countries) is associated with reductions in profitability, lower noninterest income, and lower overall expenses of domestic banks. South–South foreign banking is too recent a phenomenon to permit a judgment about whether entry by banks from developing countries produces the same effects. It is possible that developing-country banks are less sophisticated in technology and banking practices, so that they would not generate the same degree of competition and hence not lead to the same efficiency gains. Alternatively, as argued elsewhere in this chapter, host countries may find it easier to adapt technology from other developing countries, thus increasing spillovers. In the absence of empirical work, one can only speculate on which effect may be more important.

South–South banking has the potential to direct capital away from the source country, thus reducing the supply of credit available to market participants that are already credit deprived. This can happen when total lending by participating banks is constrained by their available capital or the availability of skilled staff (as opposed to being constrained by the lack of investment opportunities in the domestic market). As capital is scarce in most developing countries, it is widely presumed that domestic lending is constrained by capital availability, at least in countries where the investment climate is adequate to support increased economic activity. The fact is, however, that in some countries the poor investment climate severely reduces the availability of profitable investment opportunities; in such cases banks' cross-border lending may not reduce the effective supply of domestic credit.

Entry by developing-country foreign banks may increase credit volatility. In general, foreign banks increase credit volatility if they quickly decrease their exposure to the country when domestic conditions deteriorate (Caballero 2002) or reduce their lending when deteriorating economic conditions in their home country reduce their capital. On the other hand, foreign banks may reduce credit volatility because they are less reliant on erratic local deposits—their reputation for soundness may attract local deposits during a credit crisis, thus reducing outflows from the domestic financial system.

Overall, developing-country banks may make a greater contribution to instability than industrial-country banks. Developing-country banks are more likely to be subject to financial crises in their home country than are industrial-country banks, and thus are more likely to reduce credit due to sharp changes in their capital. For example, banks from Latin America are more likely to react with a reduction in credit when they experience a reduction in real deposits than are banks from developed countries (IDB 2002). Furthermore, the less secure reputations of developing-country banks indicate that they may play a less important role in attracting local deposits during a domestic credit crisis.

Developing-country stock exchanges

Emerging trends in regional versus international integration

A feature common to many nations' efforts to develop their financial sectors over the past several decades has been the establishment of a national stock exchange—or the expansion of an existing one. It has been argued that such a development can be an important step toward a modern, well-functioning financial sector—as a means of increasing and improving the allocation of savings and investments.[40] Many international organizations, including the World Bank, have supported these efforts (IFC 1991). As a result, there are currently some 85 stock exchanges operating in some

75 developing countries.[41] Many of the exchanges have very low ratios of market capitalization to GDP and are characterized by lack of depth (low turnover), inadequate transparency, operational inefficiency, and poor regulation, calling into question the notion that they contribute to efficient resource mobilization and allocation.[42] Consequently, in the past several years, there has been growing interest in the possible advantages of consolidating national stock exchanges in developing countries and so addressing the impediments of small size, illiquidity, and inadequate market infrastructure (table 4.7).

Table 4.7 Stock exchanges in selected developing countries, December 2005

Market	Company listings	Market capitalization ($ millions)	Market capitalization as % of GDP	Annual turnover ratio (%)
Botswana	18	2,438	25	2.1
Ecuador	32	3,215	98	4.2
Ghana	30	1,661	21	3.2
Latvia	45	2,527	16	7.9
Oman	96	15,269	45	31.5
Philippines	235	40,153	44	14.0
Sri Lanka	239	5,720	26	18.3
Trinidad & Tobago	37	16,971	120	3.8
Tunisia	46	2,876	10	8.9
Ukraine	221	24,976	35	2.5

Sources: Standard & Poor's, *Emerging Stock Markets Review* (January 2006); Standard & Poor's *Global Stock Markets Factbook,* 2005; World Bank database (for GDP data).
Note: Annual turnover ratios are calculated by dividing the total value traded in 2004 by average market capitalization for 2003 and 2004.

Limited progress toward regional integration, but some positive signs

Stock exchanges across developing regions have introduced various initiatives over the past decade to forge closer regional links both intraregionally and, in some cases, extraregionally. Thus far, however, actual progress toward merging or integrating stock exchanges among developing countries has been limited.

Many developing-country capital markets remain more integrated with the major international financial markets than with other developing countries. In part, this is due to a lack of intraregional harmonization of tax, accounting, disclosure, and other stock-market listing and trading regulations and procedures. In Asia, for example, stock markets remain fragmented and poorly integrated, and cross-border listings between developing-country exchanges remain uncommon.[43] Overseas listings by companies domiciled in Asian developing economies are still more likely to take place via depositary receipt and other issues on developed-country exchanges, particularly in Hong Kong (China), Singapore, Japan, New York, London, and, increasingly for South Asian firms in recent years, Luxembourg.[44] Cross-border listings by firms in southern Africa on the Johannesburg and other national exchanges in the subregion are not uncommon.[45] However, many of the largest South African companies moved their primary listings from Johannesburg to the London Stock Exchange (particularly during the 1990s), citing a need for access to a much larger capital market.

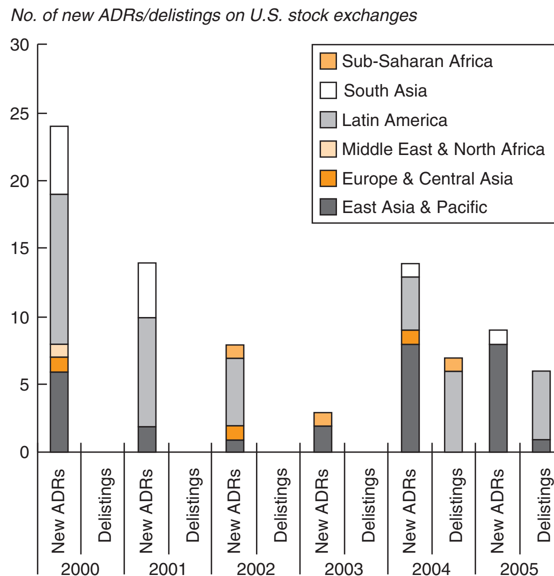
Neither Asia nor Latin America has taken a strong intraregional approach—at least in practice—toward developing national equity markets. In Asia, the focus of intraregional initiatives in recent years has been bond markets—via the ASEAN+3 initiatives to develop an intraregional bond market. But, so far, although issues of foreign currency–denominated bonds by Asian sovereigns and private firms have increased, most tend to be denominated in U.S. dollars, and most of the investment in these issues is sourced from Europe or the United States—albeit with a significant amount coming from Asian investors residing there.[46]

In Latin America, by contrast, recent efforts to develop capital markets have focused on the equity markets and have included some plans that take an intraregional approach. The region's two largest exchanges, in Mexico and Brazil, signed an agreement in 2005 that will soon allow cross-border investments in shares on their exchanges. Since the 1990s, the MERCOSUR countries have taken steps to encourage more cross-border trading in the markets of Argentina, Brazil, Paraguay, and Uruguay. Nevertheless, the actual volume of cross-border listings and investment in intraregional securities between developing countries in Latin America remains small.[47]

Steps to increase intraregional cooperation—rather than outright integration—as a means of developing national capital markets are increasingly evident, particularly in the form of an increase in agreements between developing-country stock exchanges to encourage more cross-border listings and investment, information and technology sharing, training, and staff exchanges. Some

Figure 4.6 Developing-country firms shift away from ADRs

No. of new ADRs/delistings on U.S. stock exchanges



Source: Bank of New York Depositary Receipts Division.

of these agreements also promote joint efforts to develop new financial products and develop the stock-brokerage profession. A growing number of such cooperation agreements has been signed with exchanges outside the region—in developed as well as other developing countries.

Signs of a move away from American Depositary Receipts (ADRs) and toward more local listings

Developing-country firms may be less likely in the future to list on major international financial centers' markets than on domestic markets. In part, this is due to the recovery of trading activity and share prices in developing-country stock markets—reversing the downturns of the late 1990s (see box 2.2). That recovery has been driven by rapid economic growth and greater corporate earnings, as well as by local stock-market regulatory reforms to increase local trading activity, attract more investors and issuers to local and regional markets, and improve efficiency and competitiveness. There also is an ongoing effort—apparent across all developing-country regions—to bring financial reporting and disclosure standards more in line with international standards.

At the same time, increased regulatory and disclosure requirements in industrial-country markets, and their associated costs, are giving some impetus to local initiatives to develop capital markets, including those taking an intraregional approach. More costly and complicated documentation requirements, and significantly increased human resource and other capacity requirements for compliance with the more stringent reporting standards of Section 404 of the U.S. Sarbanes-Oxley Act of 2003, have coincided with an apparent decline in the attraction of an overseas listing on a U.S. exchange in recent years—particularly for companies based in Latin America, and also for many companies based in Asia (see figure 4.6).[48] New issues of depositary receipts by Latin American firms on U.S. exchanges declined from 11 in 2000 to none in 2005.[49] Moreover, there were six delistings of ADRs in 2005, five of which involved Latin American firms. At the same time, more companies in middle-income countries in Latin America and elsewhere have made initial public offerings (IPOs) or other forms of share issues in recent years (see also figure 2.9).

More must be done to improve financial intermediation at the national level

Regional cooperation and, possibly at a later stage, integration could improve the liquidity, efficiency, and competitiveness of securities exchanges in developing countries. But for many emerging markets, further progress in developing well-functioning national securities markets (and financial markets generally) is needed ahead of moves to integrate those markets. Hasty integration of several small, illiquid national stock markets would likely create nothing more than a large, illiquid regional market. Short of full integration, underdeveloped national exchanges could meanwhile benefit from the steps they have been taking to encourage closer cooperation, including through cross-border listings and investment, and through information and technology sharing.[50] More intraregional trading activity could also facilitate the privatization of large corporations, by providing a market for large share issues that could not be absorbed on a national basis.

Beyond general progress in strengthening national financial markets, several steps are important at the national level to facilitate eventual

cross-border integration. Countries participating in cross-border trades must have convertible currencies and would have to liberalize those remaining controls and other restrictions on capital flows that impede cross-border trading, payments, and settlements. Harmonizing regulatory and policy frameworks would facilitate cross-border listing and investment and would be a prerequisite to actual integration.[51]

Conclusion

Available data indicate that more developing countries are lending to and investing in other developing countries. The expansion of South–South capital flows reflects both the general growth of cross-border financial transactions in the wake of globalization and the increasing size and sophistication of developing-country banks and multinationals. Greater South–South flows promise greater resources for low-income countries, a more efficient allocation of capital by lenders and investors familiar with developing-country conditions, and potentially greater transmission of technology and know-how from FDI.

The potential benefits of greater South–South integration are supported by anecdotes, a few empirical studies, and deduction and inference from the history of North–South capital flows, rather than by a large body systematic research. The fact is that the data on South–South capital flows are limited, and assembling those data from available sources is an arduous task (see annex 1). Moreover, very little research has been done on South–South financial integration. In part this reflects the relative novelty of developing countries as a significant source of capital, in part the absence of data, and in part the desire of development economists to focus their energies on the principal source of capital flows to developing countries (the high-income countries).

We hope that this foray into South–South capital flows will draw greater attention to developing countries as a source of capital. Greater efforts to collect data are essential to progress. Further empirical research could focus on (1) the extent of spillovers from South–South FDI and how these differ from spillovers from North–South FDI; (2) the impact of government impediments to, and incentives for, outward investment in developing countries; (3) the impact of developing-country banks on macroeconomic instability in their foreign markets, including the extent to which developing-country banks transmit crises from source to host country and whether the quality of management and financial soundness of internationally active developing-country banks differs greatly from high-income country banks; (4) the circumstances under which efforts to increase the integration of regional capital markets are likely to improve their efficiency; and (5) circumstances under which regional trade agreements and other forms of regional integration have a positive impact on economic growth and development.

Chapter 4 Annexes

Annex 1: Data on South–South capital flows

Most countries do not routinely publish data on capital flows by source country. Thus it is not possible to rely on official sources to calculate the portion of capital flows to developing countries that come from other developing countries. In constructing a database on South–South capital flows, we have relied on a variety of sources, including the Bank for International Settlements (BIS), Loanware, Bankscope, the United Nations Conference on Trade and Development (UNCTAD), the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF), and the World Bank.

Measuring South–South loans

BIS recently has begun publishing data on lending by banks domiciled in some developing countries. However, data are available only since 2000, and only for five countries (Brazil, Chile, India, Mexico, and Turkey). Moreover, data are available for all of these countries only since 2003. While the BIS data do provide some indication of the role of banks in developing countries as lenders, they cannot provide a very complete picture of South–South lending.

Most of our analysis of South–South lending, therefore, is based on data on syndicated loans obtained from Loanware, although considerable work was required to calculate the share of South–South transactions. While many transaction entries detail the allocation of loans among all participating banks, others do not, depending on the disclosure practices of particular syndicates. Where participation by all banks is disclosed, nonlocal developing-country bank participation in a loan is taken directly from Loanware. Where loan-allocation details for a particular loan transaction are not disclosed, an estimate of the cross-border South–South lending component for that transaction is derived by multiplying the total transaction amount by the average share of nonlocal South–South lending in syndicated loan transactions with some portion of developing-country bank participation arranged for borrowers in the region that year.[52]

Measuring South–South foreign bank ownership

Data on foreign banks in developing countries, as well as related financial variables, are based on Bankscope and include all active commercial banks, saving banks, cooperative banks, bank holding companies, and middle and long credit banks that were available in Bankscope as of December 2005. When ownership information is not available in Bankscope, information is gathered from banks' Web sites or other Internet sources.[53] We determine whether each bank is foreign-owned, that is, whether at least 50 percent of the bank's shares are owned by foreigners. In addition, the percentage of shares are summed by country of residence of the shareholder, and the country with the highest percentage of shares is appointed as the source country. Ownership is based on the direct ownership structure; indirect ownership is not taken into account.

Countries with fewer than five active banks in Bankscope were excluded from the sample. In addition, Guatemala was excluded, as ownership information was available for only a small portion of the country's banks. We were left with a sample of 103 developing countries. In total, the database

provides us with information on ownership and related financial variables for 2,297 banks, of which 35 percent are foreign owned.

Measuring South–South foreign direct investment

Developing countries do not report the source of FDI inflows. Therefore, data on South–South FDI flows are calculated by comparing total FDI inflows to developing countries with FDI outflows from high-income to developing countries; the difference is South–South FDI flows. First, FDI outflows from high-income countries to developing countries are calculated. For high-income OECD countries, the OECD provides data on FDI outflows to 35 developing countries that account for 85 percent of all FDI inflows to developing countries. For high-income countries that are not part of the OECD, including several offshore centers, data on FDI outflows are taken from the IMF and UNCTAD. Since detailed destination data are not available, we assume that all of the FDI outflows from high-income non-OECD countries went to developing countries. (This assumption leads to an underestimation of South–South FDI flows.) Second, data on FDI inflows (to the 35 developing countries covered by the OECD database) are taken from the World Bank. South–South FDI flows (to the 35 developing countries) are then approximated by FDI inflows in developing countries that are not from developed countries (Aykut and Ratha 2004).

The estimation technique suffers from the several weaknesses, some of which will lead to an underestimation, some an overestimation, of South–South FDI. First, FDI outflows to developing countries may be underreported by the high-income countries. It is likely that a portion of the FDI outflows that are not identified by country go to developing countries, which would imply an overestimation of South–South FDI. Second, FDI inflows are likely to be underreported by some developing countries, which would imply that our data are underestimates of South–South FDI. Third, round-tripping of flows (the export of capital to a foreign country for the purpose of investment back in the home country, often to benefit from tax incentives) will lead to overestimation of South–South FDI flows. Fourth, transactions channeled through offshore financial centers may be misclassified as FDI. Fifth, FDI from the North may be channeled through a developing country to another high-income country (indirect FDI flows), causing an overestimation of South–South flows. And finally, relying on a sample of 35 developing countries may lead to an underestimation of the level of South–South flows.

Annex 2: Selected South–South M&A deals by southern multinationals in service sector, 2000–5

In services sector

Year	Acquiring company	Country	Acquired company	Country	Sector	Value ($ millions)
2005	America Movil	Mexico	TIM Peru	Peru	Telecommunications	500
2004	Anglogold Ltd	South Africa	Ashanti Goldfields	Ghana	Gold ores	1500
2004	Sinergy	Brazil	Avianca	Colombia	Air transportation	400
2004	CEZA.S.	Czech Republic	Capital Electricity Colombia	Bulgaria	Electric services	400
2004	Teléfonos de Mexico	Mexico	Telecomunicaciones	Colombia	Telecommunications	400
2004	Teléfonos de Mexico	Mexico	Embratel	Brazil	Telecommunications	400
2004	Vempelcom	Russia	Kar-tel	Kazakhstan	Telecommunications	400
2004	YTL Power	Malaysia	Jawa Power	Indonesia	Electric services	200
2004	Teléfonos de Mexico	Mexico	Chilesat	Chile	Telecommunications	130
2004	Teléfonos de Mexico	Mexico	Techtel	Argentina	Telecommunications	100
2002	Vodacom	South Africa	Vodacom Mozambique	Mozambique	Telecommunications	260
2002	Ressano Garcia Railways company	South Africa	Caminhos de Ferro Mozambique	Mozambique	Cyclical services	78
2001	MTN	South Africa	MTN	Nigeria	Telecommunications	285
2001	Teléfonos de Mexico	Mexico	Comcel	Columbia	Telecommunications	257
2001	Industrial Development Corporation	South Africa	Mozal II	Mozambique	Basic industries	160
2001	Vodacom	South Africa	Vodacom Congo	Republic of Congo	Telecommunications	142
2000	Orascom	Egypt	Telecel	12 African countries	Telecommunications	413
2000	Teléfonos de Mexico	Mexico	ATL	Brazil	Telecommunications	345
2000	Teléfonos de Mexico	Mexico	Conecel	Ecuador	Telecommunications	153
1998	Teléfonos de Mexico	Mexico	TelGua	Guatemala	Telecommunications	700

In extractive sector

Year	Acquiring company	Country	Acquired company	Country	Location of the acquired asset	Value ($ millions)
2005	Andes Petroleum	China	EnCana	Canada	Ecuador	1420
2005	CNPC	China	Petro Kazakh	Canada	Mainly in Kazakhstan	4180
2005	CNOOC	China	MEG Energy	Canada	Canada	120
2005	Sinopec Group (50%) and ONGC (20%)	China-India	National Iranian Oil Company	Iran	Yadavaran Oil Fields in Iran	$70–100 billion over 30 years
2004	CNPC	China	Plus Petrol Norte	Peru		200
2004	Gazprom	Russia	Lietuvos	Lithuania	Lithuania	50
2004	Metorex	South Africa	Ruashi Mining	D. R. Congo	D. R. Congo	86
2004	Rangold Resources	South Africa	Loulo Concessions	Mali	Mali	80
2004	Rangold Resources	South Africa	Licences and assets	Angola	Angola	15
2003	CNOOC	China	Tangguh LNG project	Indonesia		275
2003	CNPC	China	Oil field	Kazakhstan	N Buzachi	200
2003	Investor Group	China	Amerada Hess	Indonesia		164
2003	Sinochem	China	Ecuador Block 16	Ecuador		100
2003	Lukoil	Russia	Beopetro	Serbia	Serbia	130
2003	AngloGold	South Africa	Ashanti	Ghana	Ghana	274
2003	Impala Platinum	South Africa	Zimbabwe Plat. Mes	Zimbabwe	Zimbabwe	85
2003	Impala Platinum	South Africa	Hartley Platinum Mines	Zimbabwe	Zimbabwe	80
2003	Impala Platinum	South Africa	Platinum mines	Zimbabwe	Zimbabwe	19
2003	Sasol	South Africa	Escravos gas to liquid plant	Nigeria	Nigeria	undisclosed
2002	CNOOC	China	Repsol YPF SA	Spain	Indonesia	591.9
2002	PetroChina Corp	China	Devon Energy	—	Indonesia	262
2002	Escom Holding	South Africa	Grand Inga Falls	D. R. Congo	D. R. Congo	1200
2001	Saso Oil	South Africa	Pande Teemanegasfields	Mozambique	Mozambique	581
2000	AngloGold	South Africa	Ashanti Goldfields	Tanzania	Tanzania	83
1998	China National Petroleum Corp	China	Oil Field	R. B. de Venezuela		240.7
1997	China National Petroleum Corp	China	Aktyubinskmunaygaz	Kazakhstan		325

Source: UNCTAD and news sources.
Note: — denotes not available.

Annex 3: Model of determinants of bank ownership

The following is an explanation of the model used in box 4.4. To test the differences between determinants of foreign bank entry in developing countries by banks from developing countries and from high-income countries, we estimate the following model using Tobit:

$$\begin{aligned} FC_{ij} = {} & \alpha_1 Collinks_{ij} + \alpha_2 Collinks_{ij} * D^S \\ & + \beta_1 Border_{ij} + \beta_2 Border_{ij} * D^S \\ & + \gamma_1 Comlang_{ij} + \gamma_2 Comlang_{ij} * D^S \\ & + \delta_1 Dist_{ij} + \delta_2 Dist_{ij} * D^S + \kappa_1 Trade_{ij} \\ & + \kappa_2 Trade_{ij} * D^S + \lambda_1 GDP + \lambda_2 GDP \\ & * D^S + \mu_1 Findepth + \mu_2 Findepth \\ & * D^S + \varphi_1 Legaldif + \varphi_2 Legaldif * D^S \\ & + \theta_1 Inst + \theta_2 Inst * D^S + \rho_1 Entryres \\ & + \rho_2 GDPsource + \rho_3 GDPcapsource \\ & + \rho_4 Dregion + \tau_1 constant + \varepsilon_{ij} \end{aligned}$$

The dependent variable is defined as the ratio of the sum of assets of banks in host country *i* of which a source country *j* owns 50 percent or more equity, divided by the total amount of banking assets in host country *i*. *Collinks* is a dummy with a value of 1 if the host and source countries have had colonial links either between colonizer and colony or between those countries colonized by the same colonizer. D^s is a dummy with a value of 1 if both host and source country are a developing country. *Border* is a dummy with a value of 1 if the countries share a border. *Comlang* is a dummy with a value of 1 if the countries share the same language. *Dist* refers to the log of the distance between the host and source countries. *Trade* is the log of exports plus imports in 2000 between the two countries. *GDP* is the log of the host country's GDP in 2000. *Findepth* is the log of M2 as a percentage of GDP in the host country in 2000. *Legaldif* is a dummy with a value of 1 if the origin of the legal system of the host and source countries differs. *Inst* is the simple average of six indicators of quality of institutions in the host country in 2000 as measured by Kaufmann, Kraay, and Mastruzzi (2005). *Entryres* is a dummy with a value of 1 if foreign bank entry is restricted. *GDPsource* and *GDPcapsource* are the logs, respectively, of GDP and GDP per capita in the source country in 2000. *Dregion* are dummies for each region.

Notes

1. See annex 1 for the methods used to compile data on South-South transactions.

2. Data on bilateral remittance flows are not available. The estimate in figure 4.1 assumes that bilateral remittances are a function of the stock of migrants in the sending country. This estimate is consistent with the fact that nearly half of the migrant stock from the South migrate to another country in the South.

3. It is difficult to obtain data on foreigners' purchases of stock issues. But see figure 2.14 on initial public offerings in emerging markets.

4. The G-20 and G-90 groups were formed at the time of the WTO ministerial in Cancun in September 2003. The G-20 includes some of the larger developing countries, while the G-90 is made up of countries from the African, Caribbean, and Pacific (ACP) group, the African Union, and the least developed countries.

5. According to the index published by the Heritage Foundation. See http://www.heritage.org/research/features/index/downloads.cfm.

6. These are unweighted averages. The average for high-income countries includes non-OECD countries.

7. The discussion of RTAs is taken from World Bank (2005b).

8. World FDI in services quadrupled between 1990 and 2002 (UNCTAD 2004). By 2002, the services sector accounted for 70 percent and 47 percent of FDI stock in developed and developing countries, respectively (World Bank 2004).

9. The services sector includes electricity, gas, water, transport, communication, construction, wholesale and retail trade and repairs, hotels and restaurants, transport, storage and communications, finance and insurance, real estate, renting, and business services, public administration, defense, education, health, social services, social and personal service activities, and recreational, cultural, and sporting activities. Not all services are nontradable or require physical proximity.

10. For example, America Movil (Mexico) bought out the shares of its partners (SBC and Bell Canada) in Brazil and of its partner (Bell Canada) in Colombia in 2002.

11. See Goldstein (forthcoming) and Pradhan (2005).

12. Examples include the Indian R&D center of Chinese white goods producer Haier, and Russian design and R&D centers for the shipping industry and drilling platforms (Vahtra and Liuhto 2004).

13. The extractive industries also attract a large share of developed-country FDI in Africa. In 2002, 53 percent of FDI from four major developed-country investors in Africa (France, the Netherlands, the United Kingdom, and the United States) was in the extractive sector (World Bank 2004, figure 3.6).

14. China has partnerships or investments in oil and gas exploration projects in Cuba, Peru, and República Bolivariana de Venezuela.

15. For example, a Turkish soap and detergent producer (Evyap) opened factories in Egypt and Ukraine and is planning to open one in Russia to escape uncompetitive

labor costs at home and growing competitive pressures in these markets (IMF–World Bank 2005). Mauritius has received significant FDI in the textile and clothing sector but moved part of its production to lower-cost neighboring Madagascar and Mozambique in response to cost pressures from Asia (Goldstein 2003).

16. In June 2005, India's Ranbaxy won approval to make lamivudine tablets for Africa under the U.S. President's Emergency Plan for AIDS Relief.

17. Examples of SOEs in other sectors include Telekom Malaysia, Eskom, and Transet of South Africa.

18. For example, South African SOEs have invested in Africa in part to promote the New Partnership for African Development (UNCTAD 2005a).

19. In July 2005, China's CNPC was awarded four oil blocks in Nigeria in exchange for investing in the construction of a hydropower plant ("China Goes Shopping," *Financial Times,* March 8-16, 2005).

20. SMEs have 1,000 or fewer employees (OECD 2005a).

21. Since 1998, the Tata Group has been selling a family sedan for $4,000 to $6,000. It announced plans to introduce a $2,000 car by 2008 ("Getting the Best to the Masses," *Business Week,* October 11, 2004).

22. Positive spillovers are benefits that the domestic economy enjoys but does not pay for, due to the presence of foreign firms. Such benefits may include the availability of information and technology or the increased supply of trained workers (where, because of job mobility, the foreign firm does not capture the full return to training).

23. Some of these initiatives are the OECD Guidelines for Multinational Enterprises, the OECD Convention Against Bribery of Foreign Public Officials in International Transactions, and various initiatives that promote transparency in the extractive industries.

24. A survey of 200 outward investors from Eastern Europe and Central Asia (Sevtlicic and Rojec 2003) showed that most companies that have invested abroad—mainly in other developing countries—increased exports and improved their financial performance. In India, outward investment enhanced the export performance of SMEs in manufacturing, compared with those that did not invest abroad (Prahdan 2005).

25. See *The Banker* (2005), *Global Finance* (2004 and 2005), Capital Intelligence (2004 and 2005), *EIU Country Finance* (2004 and 2005), *Latin Finance* (2005), and information posted on various bank Web sites.

26. Data reflect participation by nonlocal developing-country banks in cross-border syndicated lending to borrowers based in developing countries (see annex 1).

27. This increase is due in part to the rise in the number of countries following the breakup of the Soviet Union. Seven of the former Soviet republics received syndicated lending in 2005.

28. Examples include the State Bank of India and Oman's Bank Muscat.

29. In a sample of 1,143 cross-border syndicated loan transactions, local banks in eastern Europe accounted for 13 percent of the total loan amount, and local banks in Latin America for 16 percent (Nini 2004).

30. A mandated lead arranger is a bank (or banks) responsible for originating, structuring, and syndicating a loan transaction.

31. This includes international transactions of the banks with any of their own affiliates and with Panama, an offshore center. Excluding Panama, cross-border lending originating from developing countries amounted to $77 billion in 2005

32. Foreign claims include cross-border loans by the bank's head offices or its affiliates, and local loans by affiliates located in another country

33. Total assets are averaged over 2000-4. These numbers include offshore centers. Excluding FDI in and from offshore centers, developing-country banks hold 3 percent of foreign bank assets in developing countries.

34. The data for South Asia reflect banks domiciled in Mauritius (an offshore banking center), most of which owned by banks from high-income countries that have set up subsidiaries in India.

35. Excluding FDI to and from offshore centers, Sub-Saharan Africa shows the highest percentage of developing countries' banks in total foreign bank entry (13.3 percent), followed by East Asia and the Pacific (10 percent), and the Middle East and North Africa (6.6 percent). In the other regions South-South activity accounts for less than 2 percent of FDI in the banking sector.

36. Some banks, such as India's Bank of Baroda and the State Bank of India, Jordan's Arab Bank, and the Bank of China have been active participants in cross-border syndicated transactions for borrowers outside their regions since at least 1985.

37. Examples include plans by a number of Kazakh banks to offer financial leasing services (a growing financial product geared to SMEs) in Eastern Europe and Central Asia. Evidence on the kinds of financial services provided by developing-country banks can be found in *Capital Intelligence* (various country reports through the end of 2005), *The Banker* (various issues in 2005), and information provided on the banks' Web sites.

38. This discussion is based on conversations with World Bank staff.

39. The prosecution was reported in Zambia News Online. http://www.africa.upenn.edu/Newsletters/zno24.html

40. Engberg (1975) saw a role for capital markets in raising domestic savings and contributing to their more efficient allocation, even in less developed economies. Engberg also argued that the broader range of financial assets associated with capital market development could raise personal savings rates. Levine (1990) showed that a stock market can positively impact growth by providing a means of trading the ownership of firms (shares) without disrupting the operating and productive processes within those firms and by providing a way for investors to diversify their portfolios. See also Demirgüc-Kunt and Maksimovic (1996); Boyd and Smith (1998); Levine and Zervos (1998); Arestis, Demetriades, and Luintel (2001).

41. The number of countries with a stock exchange is actually greater than 75, but several exchanges are inactive or have negligible trading activity.

42. Forty-six of the 80 stock markets categorized as "emerging markets" in Standard & Poor's *Global Stock Markets Factbook 2005* had a market capitalization of $10 billion or less in October 2004. In contrast, just 3 of the 29 developed-economy stock exchanges had a market capitalization of $10 billion or less. Stock markets in many developing economies rival those in developed economies when viewed in terms of the ratio of market capitalization to gross national income, however. Market capitalization is only one factor in determining the relative level of development of a stock exchange (Standard & Poor's 2005).

43. According to the IMF's *Asia-Pacific Outlook*, September 2005, at least 95 percent of the listings on Asian national stock exchanges are local listings.

44. Indian firms issuing global depositary receipts (GDRs) on the Luxembourg Stock Exchange (citing cost, time, and marketing advantages) accounted for the majority (23) of the 42 total depositary receipts newly issued on the main depositary receipt listing markets in 2005 (the United States, the United Kingdom, and Luxembourg). The issuance of GDRs by developing-country firms may improve efficiency in the home market due to increased competitive pressures on standards, procedures, and operations, but it may also impose costs due to diversion of order flow abroad. The net impact on market liquidity and capitalization from cross-border listings may depend on the proportion of trading volume that shifts overseas, relative sizes of the home and overseas markets, and changes, following the cross-border listing, in the extent of home-market segmentation due to investment barriers and intermarket information transparency (Hargis and Ramanlal 1996; Hargis 1997; and Domowitz, Glen, and Madhavan, 1998). More recent research (Karolyi 2004) found that an increase in issues of American Depositary Receipts (ADRs) by firms in an emerging market economy may be a result, rather than a cause, of deteriorating local market conditions.

45. More than 70 percent of the equities listed on the Namibia Stock Exchange (NSX) are dual listed on the Johannesburg Stock Exchange, and the vast majority of NSX trading takes place in these dual listed stocks (Johannesburg Securities Exchange 2005). For a region-specific assessment of whether cooperation and integration of stock exchanges in southern and eastern Africa could offer a way of overcoming impediments to the development of these exchanges, see Irving (2005).

46. Bank for International Settlements, 2005.

47. Despite a significant amount of foreign investment in securities traded on the region's two largest exchanges, in Brazil and Mexico, the vast majority of it comes from developed economies.

48. In October 2005 China Construction Bank, which had reportedly been considering a listing on the NYSE, opted instead to list on the Hong Kong, China exchange, with an IPO of $8 billion—China's largest to date and the largest worldwide since 2001. In the past few years, the international financial press has contained numerous additional reports of firms domiciled in developing countries that have abandoned plans to list on the major U.S. exchanges and, to some extent, on the London Stock Exchange, because of more onerous listing requirements and associated higher costs. The European Union also has been taking steps to increase the stringency of its reporting and disclosure requirements for companies that list on EU stock exchanges, including through a transparency directive slated to take effect in 2006.

49. Although a Chilean firm issued new ADRs in 2005, this transaction was an exchange of existing depositary receipts due to a company merger.

50. The impact of South–South cross-border listings on developing countries' stock exchanges is an important area for research, given the increasing number of agreements between developing countries' stock exchanges that encourage cross-border listings and investment.

51. This would involve harmonizing not only stock-market regulations, listing requirements, and procedures for trading, clearing, and settlement, but also transaction fees, accounting and disclosure standards, corporate governance standards, common standards for stockbrokers, and national rules for capital gains and withholding taxes. Such efforts, as well as the development of common infrastructure and systems, may have to address limitations in national markets, such as poor institutional capacity for enforcing regulations, rudimentary stock-market infrastructure, poor and unreliable access to information and communications technology, and exchanges at significantly different stages of development. A regional securities regulatory body would be essential if integration were to proceed to the point of forming a regional exchange.

52. For example, the South–South cross-border lending component of a qualifying syndicated loan ("loan A") for a borrower in East Asia in 2005 that does not reveal loan-allocation details is estimated by multiplying the average share (15 percent) of nonlocal South–South lending in all qualifying transactions for East Asia that reveal loan-allocation details by the total "loan A" transaction amount. A qualifying transaction is defined for this purpose as a syndicated loan disbursed to a borrower in a developing country, whereby one or more banks domiciled in other (nonlocal) developing countries participate in the syndicate. In cases where loan-allocation details are unavailable for all qualifying syndicated transactions in a particular region, as in Latin America in 1985 and 1995 and in the case of all regions in 1985 (with the exception of two transactions), the estimate is derived from an average of all transactions that provide loan-allocation data for the region in the time series.

53. Currently our sample does not include Costa Rica, the Dominican Republic, or Panama.

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