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## Foreign banks and the export performance of emerging market firms: Evidence from India



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### ABSTRACT

This paper assesses the case for foreign banks as part of a program of institutional reform geared toward export promotion in emerging market economies. It does so by empirically evaluating the impact of foreign bank participation on the export performance of emerging market firms. It hypothesizes that foreign bank participation will not have a statistically significant moderating effect on the anticipated positive relationship between firm size and export sales. Using an unbalanced panel of 930 firm-year observations for Indian chemical firms over the period 1997–2005, it employs the two-stage least squares (2SLS) method with fixed effects to estimate a simultaneous equations model. The empirical evidence suggests that higher foreign bank participation in the domestic banking sector may attenuate the positive firm size–export sales relationship; however, this mediating effect is not significant in both statistical and economic terms. The main policy implication is discussed.

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## 1. Introduction

In recent years, there has been a growing interest in the issue of whether foreign banks should be welcomed by domestic policymakers in emerging market economies characterized by inefficient domestic banking systems (Mathiesen and Roldós, 2001; Moreno and Villar, 2005). One of the strongest arguments in favor of foreign banks seems to be based on the traditional *market power* view that

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emphasizes the efficiency property of a competitive banking system. According to this view, the entry of foreign banks in the domestic banking system will induce competition among banks, and lead to an increase in the supply of cheaper credit (Bayraktar and Wang, 2004; Claessens et al., 2001; Denizer, 2000; Hasan and Marton, 2003). If emerging market firms have better access to low-cost credit, the argument goes, then they may be able to grow to an optimal size that will enable them to drive economic growth in a sustainable way (Ayyagari et al., 2007; Beck and Demirgüç-Kunt, 2006; Levine, 1996).

Despite the anticipated benefits of a competitive banking system, there are several reasons why domestic policymakers in emerging market economies should exercise caution in their approach to foreign banks. First, even if the entry of foreign banks in the domestic banking sector makes it more competitive, this does not necessarily mean that credit supply will increase at a lower price as the market power view suggests. According to the *information hypothesis*, a more competitive banking sector may make it unprofitable for banks to invest in the generation of propriety information on potential clients. This in turn may lead to an under-investment in relationship-building activities that generate the soft information that is required to finance informationally opaque small firms (Petersen and Rajan, 1995). Therefore, these small firms may have less access to finance as more foreign banks enter the domestic banking sector.

Alternatively, given their limited propriety information on potential domestic clients, foreign banks may employ lending technologies and offer banking services that primarily cater to the most profitable large domestic firms that already enjoy access to credit on favorable terms relative to their small counterparts (Dell’Ariccia and Marquez, 2004; Sengupta, 2007). Moreover, this ‘cream-skimming’ phenomenon may tighten the financial constraint faced by small emerging market firms (Gormley, 2010).

Finally, foreign banks may also constitute a potentially destabilizing force in the domestic banking sector because they are inclined to assume greater risks relative to their domestic counterparts (Hellman et al., 2000). In addition, they have an incentive to pursue an early exit from the domestic economy in the event of a major financial crisis (Agénor, 2003; Crystal et al., 2001); yet, it is precisely during such a debacle that credit flows must be maintained in order to moderate the tendency toward a major contraction in economic activities.

Even if one were prepared to treat the adverse implications of foreign banks for the stability of the domestic banking system as being manageable (Agénor, 2003), emerging market governments are still likely to be very concerned about the prospect for lower credit flows to indigenous firms as more foreign banks enter the domestic banking system. This is so because the financial constraint faced by the typically small-firm dominated private sector may exacerbate under the ‘cream-skimming’ phenomenon that is associated with foreign banks. Moreover, if a competitive banking system may have either favorable or adverse implications for credit supply, then it remains unclear whether domestic policymakers in emerging markets are actually in a position to craft coherent policies on foreign banks.

Carbó-Valverde et al. (2009) address the apparent ambiguity in the effect of competition on credit supply by reconciling the market power view with the information hypothesis. In principle, the authors suggest that less competition in the domestic banking sector need not lead to a significant reduction in credit supply if policymakers remove restrictions on the scope of banking activities. As a practical matter, however, it remains unclear how policymakers may optimally balance the opposing market power and information-production effects of competition on credit supply. Thus, emerging market policymakers still appear to face a major gap in knowledge. This in turn makes it difficult for them to formulate policies on foreign banks that are intended to advance the export-promotion objective of emerging market governments.

This paper attempts to narrow this knowledge-gap by providing an alternative approach that directly addresses the question of whether foreign banks, as part of a program of institutional reform, may advance the export orientation of emerging market economies. Specifically, it empirically investigates the impact of foreign bank participation – as defined by the share of total domestic banking assets that is controlled by foreign shareholders with 50 percent or more ownership in domestic banks (Claessens et al., 2008) – on the export performance of emerging market firms. It hypothesizes that foreign bank participation alone will not have a statistically significant moderating effect on the expected positive relationship between firm size and export performance. However, the confirmation

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