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Emerging Banking Systems

Edited by

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Contents

List of Tables

List of Figures

Foreword

The emerging countries on which this book focuses are not typical emerging countries. As far as their population is concerned they are all large, ranging from the huge (India and China) to the very large (Brazil and Russia) to the just large (Turkey). Their GNPs are also much bigger than those of the average emerging country. Only when GNP per head is considered do they fall back into the picture of typical developing countries – Turkey and Russia slightly looking down on the rest of the group.

Their banking systems, however, are much more like those of average emerging countries. They have developed from initial conditions that in some cases may appear very idiosyncratic. This is, however, superficial: if one looks more closely at each individual case study contained in this book, one soon realises that similar patterns emerge among all of them. One could say that starting from a socialist banking experience, as was the case of Russia and China, is very different from the experience of the others, of other emerging countries, of developed countries. But, is it really so? We could say that in the recent experience of the US and UK, for instance, to quote two countries that superficially looked as if they had purely private banking systems run for profit, substantial state involvement was present even before the current financial crisis, where it came back into fashion with avengeance: suffice it to quote the mortgage sector in the US since the second world war and the remarkable Bank of England involvement in industrial banking in the 1920s and 1930s (a little-known subject, which is currently receiving some attention on the part of economic historians). We do not have to remind readers of course of F. D. Roosevelt's Reconstruction Finance Corporation or of the much more recent Resolution Trust Corporation, which was given the task of solving the Savings and Loans Crisis in the 1980s.

Looking at a more distant past, is there much difference between the size and role of famous banks of issue like the Banque de France and the Bank of England in their respective credit markets at the start of the nineteenth century and that of monobanks like the Russian Central Bank or the People's Bank in China? As far as long-term 'special banks' are concerned, developed countries' banking history is even more similar to that of the countries analysed in this book. *A fortiori*, this book's case studies overlap even more with one another.

There is, however, enough idiosyncrasy left in the individual cases studied by the authors to make reading their chapters a very worthwhile and intellectually challenging pursuit. Let us take Russia and China to begin with. The fragmentation process that occurred in both countries' banking systems after the demise of the monobank created very different results, as far as the banking systems' liabilities are concerned. In China individuals and families, not having experienced runaway inflation for several decades, keep their hard-earned savings almost exclusively with banks. There is a lot of cash under mattresses, but no more than is common in other countries at China's stage of development, and especially personal income level. Wise behaviour on the part of the governing class has spared economic turmoil and hardship. Prices have increased at quite a moderate pace, if we consider the speed at which the country has grown. The exchange rate's relative stability since 1995 is, of course, an important part of the explanation. The demise of the welfare state, which has occurred at the same time, has emphasised the need for private savings, and fast growth under stable conditions has given many people in China the chance of accumulating savings in the form of bank deposits.

Not a very sophisticated portfolio allocation, we might say. Let us, however, keep in mind what Italians and Germans used to do until only too recently: they spread their eggs in very few baskets, owner-occupied houses, bank deposits, post-office savings accounts and treasury bonds. Direct share ownership, for instance, was not very popular in these two countries with anyone except the affluent, at least until recently. Nor did Germans and Italians (nor, for that matter, the Japanese), have much money invested in pension and investment funds. Marvelling at Chinese portfolio selection is therefore inappropriate.

The Russian case is altogether different. Runaway inflation, the destruction of manufacturing industry, giant financial swindles and extreme rent-seeking behaviour on the part of a few individuals who are now among the world's richest men and women, followed the demise of the Soviet Union. Banks, for a number of years, rightly became, in the minds of ordinary citizens, places where financial swindles are hatched rather than bona fide keepers of people's savings.

After a modicum of economic stability and a long worldwide raw materials boom, the Russian banking system now looks like a more primitive version of that of Germany, Italy and the US in the two decades before and after the First World War. Banks are the financial arms of industrial empires, which make their profits mainly by the mining and transformation of raw materials. They are not interested in ordinary citizens' savings. They provide financial resources to the industrial companies of their groups, and get the latter's shares as guarantee. Russian banks are also very active in the international financial markets, where in normal times they lend short and borrow long to fund their industrial offshoots. In troubled times, they tend to become massive net short-term borrowers.

Given these stark differences in the two countries' recent economic history one must agree with the authors here when they realistically suggest greater financial sophistication to the Chinese, while their advice to the Russians is much more subdued and circumspect. The fact is that, after two decades of transition, China has an economy that has become the workshop of the world and a financial system only burdened by the lingering debt of state-owned industries, a problem that the central government is determined to get rid of with the smallest political risk, i.e. at a snail's pace. Thus, in financial matters, the Chinese leadership seems to abhor the 'cold turkey' approach, which they are periodically invited to adopt. Understandably, we may say, as Russia tries painfully to emerge from massive doses of that approach their leaders meted out in the 1990s with tragic results.

Russia seems to have much the more fragile economic and financial system even today, when its leaders proudly exhibit their massive foreign exchange reserves. They do not seem to have been able to fend off another danger, the raw material producers' curse, also called 'Dutch disease'. Their economy managed to be exempt from that only for a few years after the massive devaluation of the rouble, in 1998. Through the 'high rouble' they have managed a very peculiar sort of 'trickle down' by which even ordinary citizens can afford sophisticated consumer products and foreign holidays. It is however rather odd that a very large country like Russia now imports most of its automotive products (it is the largest importer of cars in Europe) and household appliances, relying on extremely volatile raw material exports and short-term capital imports to finance even its domestic payments system.

The other banking systems studied in this book belong to more traditional developing countries, although, as I have said before, they are huge, very large, or just large. Two of them are former colonies, one was always independent. Nonetheless, the growth of their banking systems seems to have gone through similar stages, with huge publicly owned special banks dedicated to long-term finance and, in some cases, even publicly owned commercial banks, dedicated to gathering private deposits and lending out short-term commercial lending.

All three countries have seen, much more than China has, the growth of private banks, some of them extremely successful in developing lines of business that imitate best practice in developed countries. All three now permit a measure of involvement by foreign banks in their domestic markets, as does China, which, however, is even more careful than the others in allowing only a minority foreign shareholding in its largest banks. The other three do allow free-standing foreign banks to operate in their domestic markets, but try to keep their operations under close scrutiny. Most of all they seem keen to avoid big name, strong foreign banks monopolising the deposits of the local monied classes. Under the circumstances in which these countries still find themselves, this approach appears reasonable: Italians, for instance, know that allowing foreign banks into the domestic retail market has meant that often not the best foreign banking practices have been exported to Italy. More often foreign banks have practised deposit skimming and resorted to 'what the market will bear' pricing, maximising profits because of lower operational and funding costs rather than aggressively trying to increase market shares by price or service competition.

If we look at all the cases analysed by the authors in this book, only in one of them, Russia, have soft budget constraints and financial repression typical of socialist banking been completely destroyed. What has replaced them is admittedly very different but not particularly positive for the Russian economy or for the Russian saver. Soft budget constraints and extensive financial repression are a prominent part of the other countries' recent past, too. The latters' governing elites, however, have decided to choose a path to financial liberalisation which, prudent and moderate as it is, reminds us much more of what has happened and is still happening in Europe.

MARCELLO DE CECCO

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Introduction

P. Bongini, S. Chiarlone and G. Ferri

Over the last 25 years, breathtaking global economic integration has taken place as a result of reductions in transaction costs (transportation and ITC, mainly) and the removal of relevant obstacles to international trade and investment. Such a context has helped emerging economies integrate within the global economy: this integration involves both their real and financial sectors.

On the real economy side, such inclusion has been more pronounced in Asia and for transition economies. As world trade has been outpacing other forms of growth – global trade has grown at an average annual rate of 5.5 per cent between 1960 and 2006, e.g. 2.4 percentage point higher than world GDP – emerging economies have increased their exports-to-GDP ratio, which has risen from 20 per cent in 1984 to 35 per cent in 2004 (World Bank, Global Economic Prospects 2007, Managing the Next Wave of Globalization). An important role has been played by growing amounts of foreign direct investments (FDIs) in emerging countries, mainly connected to production offshoring by highly industrialised countries. FDI flows rose from US$20 billion in 1990 to more than US$200 billion by mid-2000. As a consequence, emerging economies have been included in global production networks and, in many cases, have been transformed in crucial crossroad of global manufacturing systems.

Reliable forecasts suggest that global growth will increasingly depend upon emerging markets. IMF estimates for 2008 and 2009 show that most of the world economic growth will depend on China's and India's buoyancy. Moreover, according to the World Bank (World Bank, 2006), over the next 25 years, emerging economies will represent 33 per cent of global GDP. Even if that does not immediately mean that emerging countries will become rich in 25 years' time, their per-capita GDP, adjusted for purchasing power, is estimated to rise from the current 16 per cent to 23 per cent with respect to the rich countries' average, while China is expected to reach 42 per cent. At the same time new middle and upper classes will emerge, increasing business opportunities for financial and corporate firms.

On the financial sector side, high saving rates and declining fertility rates should significantly boost emerging economies' total savings, thus amplifying the demand for an efficient intermediation and opening new market opportunities for banks and financial institutions in general. In particular, as a consequence of globalisation-related competitive pressures, foreign banks have become increasingly eager to extend their operations to emerging markets to exploit their product portfolios and competitive advantages. These new banking markets are likely to represent the profit pools of tomorrow. Moreover, their ballooning foreign reserves and the growing relevance of their sovereign wealth funds hint at an increasingly active role for emerging countries as financial players in the global arena.

This scenario suggests that world economy prospects increasingly depend on emerging economies. However, in spite of their success, emerging economies exhibit various fragilities. Their chief inefficiency lies in the financial system, especially banking, and such inefficiency has historically posed serious constraints to their growth. Moreover, given the increased global interdependence of financial markets and institutions, it has repeatedly led to centripetal financial crises, bursting in the emerging countries and draining investments from the periphery to the core of the world financial markets, with additional negative effects on their growth prospects.

For instance, after the mid-1990s several emerging markets were severely affected by financial crises. Asian markets were most severely hit: Indonesia, Thailand, Korea, Malaysia, and the Philippines experienced systemic crises curtailing their GDP and shaking their financial systems. Thereafter, crises hit Russia (1998), Brazil (1999) and later on Turkey and Argentina (2001). At the heart of these events lies the 'twin crises' mechanism, which links banking and exchange rate crises: the banking systems were part of the problem, because it sustained the credit boom before the crisis, either taking enormous exchange rate risk on its balance sheet or transferring it to firms. As a consequence, after the burst of the crisis the affected economies featured pervasive bank distress and closures and a widespread credit crunch negatively impinging on investment and output.

In the absence of a mechanism to manage systemic crises – e.g. even the mild Krueger proposal of 2001 was rapidly shelved – emerging economies unilaterally reduced their potential exposure to systemic crises via increased reliance on domestic capital markets for financing investment and by deeply restructuring their international position. Hence, they accumulated enormous amounts of foreign exchange reserves and switched from net borrowers to net lenders on international capital markets. However, such strategy has its own limits and drawbacks. First, the remedy might not be entirely effective, e.g. though the most recent sub-prime crisis, originates from the US, it may affect emerging economies as well, via reduced liquidity in the markets hitting banks' funding and slowing down credit growth or via reduced economic growth worldwide. Secondly, foregoing foreign capital inflows and accumulating excessive reserves is costing emerging economies (and the entire world) a lower growth.

By and large, most emerging markets have also embarked on banking restructuring after such crises. The crucial hotspot they faced was how to reduce the negative interferences either of state ownership (when government-owned banks were dominant players) or of influential vested interests (where banks were controlled by large private industrial/commercial conglomerates) in order to bestow financial institutions higher operational independence. Consolidation and privatisation are, indeed, fundamental pillars of banking reforms in emerging economies so far. In many cases, introducing international banking expertise and allowing foreign banks' entry – aimed at improving the loan supply process, at supporting banks' recapitalisation and at applying modern risk management techniques – was also crucial.

Since the end of the 1990s' consolidation in most emerging economies has led to a decrease in the number of national banks. Market-driven bank consolidation prevailed in Central and Eastern Europe as well as in Latin America, while governments piloted consolidation in Asia.

Privatisation was mainly motivated by the growing awareness that government ownership induced bank inefficiency and represented an obstacle to financial market development. The privatisation process is rather advanced in many emerging countries, even though governments often remain significant shareholders. It is worth noticing that, contrary to what prevails in most smaller-sized emerging economies, government control still prevails in China, India and Russia.

Pervasive entry revealed a growing interest in emerging economies motivated by foreign banks' drive to unfold their own comparative advantage (e.g. innovative products and services), as well as owing to foreign banks' strategic shift from servicing their multinational customers through cross-border operations to dealing with them via local subsidiaries. This switch helps make foreign banks' interests, e.g. locating in markets with high growth potential – converge with emerging economies' interests – attracting efficient foreign players. In such a scenario, foreign banks may contribute to modernising emerging banking systems in a context of reciprocal advantages. Their presence is by far the largest in Central and Eastern Europe and in Latin America. On the contrary, their penetration was much less intense in Asia, possibly because high national savings (e.g. in China) and government bail outs reduced the need for bank recapitalisation with private funding. Nevertheless, we have noticed a recent rapid intensification of (minority) foreign bank presence in China and (yet controversial) signals of openness to foreign investors in India.

Such a reform path was directed to achieve more resilient banking systems and a better credit allocation, both conducive to healthier growth prospects (banks should play a key role in reducing the risk of excess lending to overheating sectors and in granting credit to projects showing better risk/return ratios) and to easier access to international financial markets. Moreover, the restructuring of the banking system plays a crucial role in the development of the domestic financial markets for mainly two reasons: banks are key bond issuers and they may promote their customers' tapping financial markets.

Today, the key issue is whether such reforms path have been successful in making emerging countries more resilient to potential new crises. In fact, ten years after the Asian crisis, the world economy has been shaken by a deep financial crisis started in the US sub-prime mortgage lending market, whose extent cannot as yet be fully quantified but whose ramifications for the global economy are considerable.

Some of the features of the US sub-prime event are not so distant from the twin-crisis setting that hit many major emerging economies ten years ago. First, the event is marked by a deep banking crisis, where excessive bank lending had generated soft budget constraints, especially in the real estate sector. As a consequence, the US is experiencing a credit crunch and its economy is undergoing substantive deleveraging, even though more on the part of households rather than the company sector, at the time of writing. Secondly, the value of the US dollar plummeted against most currencies, particularly *vis-à-vis* the euro. However, there is a major difference as well. Namely, even though overlending in the US was fuelled by capital inflows, it was dollar-denominated. Thus, the depreciation of the US dollar is not hurting borrowers directly, as domestic currencies' devaluation invariably did during emerging economies' financial crises for domestic borrowers indebted in foreign hard currency. The other side of the coin is that the weakening of the dollar and the problems experienced by major US banks may be somewhat denting both the role of the dollar as a reserve currency and the dominance of Wall Street within the world financial market. For instance the increasing role of Sovereign Wealth Funds resident in emerging markets as 'recapitalisers of last resort' hints at a eastward rotation of the centre of gravity of the world financial market that has geopolitical consequences yet to be understood.

Notwithstanding the fact that the repetition of a grave systemic crisis exactly ten years after the Asian crises can lead to thinking of a kind of Juglar Cycle, the lesson we should perhaps learn is that systemic crises are the inevitable thorns that grow on the rose of financial liberalisation. Financial liberalisation is a beautiful flower with a heady perfume, but if you handle it without gloves there are times when you'll get pricked. Nonetheless, in order to understand lessons for emerging banking systems, it seems worth to further analyse whether there is anything in common between the current crisis and the 1997–98 Asian crisis.

Among the differences it is important to underline that the current crisis is spreading outwards from the centre and not originating in the periphery. In addition, unlike the sub-prime mortgage crisis, the one in Asia involved few financial innovations. But there are also two remarkable similarities. In the first place, in both the Asian and the sub-prime mortgage crises, credit was granted to subjects who should not have received it (at least not to such an extent): the *NINJA loans – no verification of Income, Job status or Assets* – instrumental in the sub-prime crisis mirror the excessive reckless lending of the major credit institutions from the industrialised countries when they extended credit to the Asian tigers on the eve of the 1997–98 crash. Secondly, just as the explosion of the Asian crisis shrivelled the emerging markets, today the crisis has dried up many segments of the global financial markets, including the interbank market.

Hence, the main common way out of the crisis refers to risk re-pricing in the concerned sectors. Today, what can be seen as a problem of lack of liquidity really comes down to the extreme difficulty of assessing counterparty exposure. We saw it in the summer of 2007 and during the first semester of 2008, with the huge cash injections by the Fed, the European Central Bank and the Bank of England, which nonetheless failed to produce as great a reduction in inter-bank lending rates as they would have done under normal circumstances. That is because, in the flurry of the crisis, each individual creditor bank is unable to establish with any real certainty the debtor counterpart's exposure to sub-prime losses. So, banks preferred to hold on to liquidity, either as cash or as government securities, which are now 'worth their weight in gold', exactly as it happened in 1998, when the escalation of the flight to quality into government securities was one of the principal causes of the LTCM débâcle. In the