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The Determinants and Effects of Foreign Bank Entry in Argentina and Brazil: A Comparative Analysis

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Introduction

In the recent years, foreign bank entry has increased a great deal in emerging market economies (EMEs). Latin America and the transition countries of Central Europe –where in some countries foreign banks have already over fifty percent of total banking assets– have been quickest to permit foreign participation in banking, while in Asia, Africa, the Middle East, and the former Soviet Union, progress has been much more modest. In one hand,

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this trend is a consequence of the process of banking internationalisation of some financial firms that result from both financial deregulation and technological changes that have changed deeply the landscape of banking industry all around the world. Financial institutions are seeking to diversify their activities –in terms of products and services, or geographically– and to increase their minimum scale of operations to remain competitive and to enhance their ability to generate profits. On the other hand, foreign bank entry, particularly in EMEs, is the result of the flexibility of the legal rules concerning the treatment related to foreign bank penetration. Its motivation is mainly related to the possible benefits of foreign bank penetration in terms of modernisation and strengthening of the domestic financial system.

The recent expansion of foreign banks in Latin American countries is very impressive in terms of its rhythm. A IMF (International Monetary Fund) study relates that the participation of foreign banks from Spain, United States (US), United Kingdom and Netherlands in the total Latin American banking assets grew quickly, changing deeply the ownership structure of the financial system (Clarke *et al.*, 2001). This development reflects a new banking strategy of international expansion. Banks have not expanded abroad only to serve its home multinational enterprise or to explore opportunities that come from international trade, but also, and increasingly, to dispute domestic markets with local banks in host countries. This transnational rivalry between banks is accompanied by bank functions redefinition. The traditional lending-deposit business that no longer characterized banking firms was shifted by the universal global bank that combines ancient commercial functions with activities proper of investment banks. The diversification of financial activities is one of the new aspects of banking competition and it has been responsible by the development of securitization and new connections between financial markets and credit markets.

Argentina and Brazil experienced a simultaneous process of foreign bank entry after the 1994-1995 Mexican crisis. The quick pace of growth of foreign banks into the Argentine and Brazilian banking system was seen by the monetary authorities as a solution to face the effects of Mexican crisis over the domestic financial system. According to the literature, with

the entrance of foreign banks, emerging countries could (i) have better access to foreign savings, an essential ingredient to finance development; (ii) enhance financial system increasing its soundness in order to improve the countries' resistance to shocks; (iii) incorporate new financial technologies, introducing new management methods and new financial products; (iv) to improve operational efficiency of banking sector (Levine, 1996; Peek and Rosengren, 2000). It was expected that this set of changes would converge to growing credit facilities and strengthening historically incipient domestic capital markets.

The results of foreign bank entry in Argentina and Brazil, however, did not reach what was expected initially. The evidences show that financial system efficiency, that is, the financial system capacity to create finance to sustain production and investment, has not improved in Argentina and Brazil. The increased presence of big foreign global banks in Argentine and Brazil, since 1995, has not resulted in a sustainable credit growth; the macroeconomic instability has been the hallmark in the two countries.

This paper aims at analyzing the recent experience of foreign bank entry in Argentina and Brazil, focusing on its determinants and effects.[1] It is divided in 5 sections plus this introduction. Section 2 examines the concept of efficiency of the financial system, with special emphasis on the effects of foreign bank entry in EMEs. Section 3 analyses the determinants of foreign bank penetration in Argentina and Brazil, while section 4 examines its effects on the domestic financial system. Finally, section 5 summarizes the main arguments developed in the paper.

Financial system efficiency and the foreign banks

The concept of efficiency of financial systems is a measure of its success in reaching macro and microeconomic efficiency. Efficiency has two distinct

[1] The paper focuses mainly on the period of economic instability of Argentina and Brazil. For this reason, we do not analysis the recent economic recovery of both economies.

functions: one concerns the stability of the financial system; another is related to the allocation of the real resources. Macroeconomic efficiency concerns to the stability of the financial system, both as a payment system and as an intermediary of loanable funds, that is how financial system supports financially stable growth. Microeconomic efficiency relates to the ability to provide finance and funding for the investors and other economic agents at the lowest possible cost.[2]

Microeconomic efficiency means that bank spread must not be greater than the necessary to cover the interest paid, administrative costs and credit risk. The literature points out that the increasing presence of foreign banks could bring positive effects to the degree of efficiency of the domestic financial system, as foreign banks are generally more efficient than domestic competitors (Clarke *et al.*, 2001). For example, Focarelli and Pozzolo (2000) argue that foreign banks go to developing countries in order to explore the relative inefficiency of domestic banks. In general, banks that expand abroad are typically the "best of the crop" in the country of origin. They show that foreign banks are more efficient than domestic banks in EMEs, introducing into the host countries better practices of management and new technologies. Thus, one can conclude that the increase presence of foreign banks must improve the microeconomic efficiency, lowering the costs of supply of credit.

Macroeconomic efficiency is obtained when banking system provides loans in sufficient volume to finance investments and other spending in order to achieve full-employment with the possible minimum increase in financial fragility. In globalized open economies, the functioning of the banking system must avoid vulnerability to international rate of interest and exchange rate shocks in order to be considered as efficient.

The empirical literature presents some evidences of positive macroeconomic impacts associated with the increasing presence of foreign banks in EMEs. First, global banks bring to the host country practices

[2] The concept of efficiency of financial systems is explored by Studart (1995-1996).

consistent with the financial and regulatory reporting requirements of their home country. As financial reports of global banks are supposed to be more detailed and better accountable than developing countries ones, the presence of foreign banks in domestic financial system is an incentive to local banks to adopt better accounting practices (Peek and Rosengren, 2000, p. 48). This, in practice, reduce the risks associated with financial intermediation and should increase credit supply.

Second, foreign banks are less sensitive to domestic shocks than domestic banks. As their portfolios are better diversified, the impact of a domestic shock, that could seriously affect domestic banks would be more easily absorbed by foreign banks.[3] If all this is true, a financial system entirely occupied by domestic banks should be more vulnerable to economic shocks than financial system with the presence of foreign entities. So, the presence of foreign banks reduce the impact of shocks over the financial system, as they are able to reestablish more quickly the financial flows to the real sector and they are less vulnerable to economic shocks.[4]

Third, the presence of foreign banks in EMEs has another function: in turbulent times, global banks are often an important source of new capital for a devastated banking sector after a crisis. As the recapitalization of banks

[3] As CGFS (2004, p. 1) states, "foreign banks' can also help to achieve greater financial stability in host countries. Host countries may benefit immediately from foreign entry, if the foreign bank recapitalises a struggling local institution and, in the process, also provides needed balance of payments financing. The better capitalisation and wider diversification of foreign banks, along with the access of local operations to parent funding, may reduce the sensibility of the host country banking system to local business cycles and changing financial market conditions. Their use of risk-based credit evaluation (and spillovers to local banks' practices) tends to reduce concentration in lending and, in times of financial distress, foresters prompter recognition of losses and more timely resolution of problems. In stress situations, foreign-owned institutions can also provide an alternative location for deposits that does not involve capital outflows".

[4] Some analysts argue that the internationalization of the financial system in Latin America would have ushered a new era of financial robustness. It is interesting, in this sense, reproduce Del Negro and Kay's (2002, p. 1) quotation of a November 2001 report by Salomon Smith Barney that states that: "One of the main benefits that the presence of foreign banks in Latin America should produce is the overall decline in systemic risk […]. We believe systemic risk in the [Argentine] bank system […] is low, as 43% of its equity is controlled by foreigners".

requires investors that were not fully affected by economic shocks, foreign banks, specially global ones, are the natural candidates to do the job.

Last but not the least, Peek and Rosengren (2000, p. 48) point out that the presence of well-capitalized foreign banks may lessen the severity of domestic shock by mitigating the extension to which the funds of worried domestic savers and investors flee the country when a shock is anticipated: a foreign bank is a safe heaven for depositors who might otherwise choose to remove their funds from the country rather than risk leaving funds in a problematic domestic bank. The safety would be granted if the host country allow deposits denominated in foreign currency, because customers would be more comfortable in placing such deposits in foreign banks that have more ready access to foreign currency during banking crisis, with the lender of last resort of the foreign bank being the central bank in the bank's home country rather than of the host country.

The penetration of foreign banks in Argentina and Brazil was seen by their national governments as an important part of the solution of banking system troubles that followed the Mexican crisis, as doubtful banks were acquired by healthy ones. However, the realities of Argentina and Brazil did not allow concluding that foreign bank brought macroeconomic efficiency to domestic banking sector, despite of the fact that foreign banks may have eventually increased microeconomic efficiency.

As we will see in the next section, there is no reason to suppose that foreign bank entry resulted in a significant improvement in the finance conditions of Argentine and Brazilian economies and also in their financial stability. Indeed, foreign bank entry in Argentina and Brazil did not cause any greater change in the banking behavior in terms of portfolio allocation, credit policy, etc. This is explained by the fact that banking behavior has been mainly determined by the macro-institutional environment of both countries, that has resulted in a convergence of behavior of both domestic and foreign banks. In particular, macroeconomic instability prevented the development of financial relations in Argentina and Brazil.

Determinants of foreign bank entry in Argentina and Brazil

Determinants of foreign bank entry in Latin America

Banking crises, deregulation and globalization of financial services have led to a significant increase in the presence of foreign banks in EMEs in the second half of the 1990s. Consolidation has accelerated recently in banking industry in EMEs, changing a traditionally highly protected industry. In this connection, Hawkins and Mihaljek (2001, p. 3) states that "global market and technology developments, macroeconomic pressures and banking crises in the 1990s have forced the banking industry and the regulators to change the old way of doing business, and to deregulate the banking industry at the national level and open up financial markets to foreign competition. […] These changes have significantly increased competitive pressures on banks in the emerging economies and have led to deep changes in the structure of the banking industry".

Although the same forces of changes are determining the process of banking consolidation in mature markets [US, European Union (EU) and Japan] and emerging markets (Asia, Latin American and Central Europe), there are some particular features when ones compare both experiences (IMF, 2001):[5]

a) International mergers and acquisitions (M&As) cross-border are an exception in mature economies, but they are the rule in emerging markets. In emerging markets it can be observed an increase in the market share of foreign banks in the domestic banking sector, while this trend is weaker in mature countries. Indeed, in the latter countries banking consolidation emerged as a consequence of financial deregulation implemented during the 1980s and 1990s, as typically is the case of US where the segmentation of the financial system was gradually being eroded. On the other

[5] See also Dymski (2002) for an analysis on the implications of the current global bank merger for developing countries.

hand, in emerging markets international M&As cross-border, involving foreign banks, in most countries have been the rule.[6]

b) Banking consolidation in mature markets has served mainly to increase the efficiency –in the search of scale economies, scope economies and revenue economies– or the market power of the major banks,[7] while in EMEs it served mostly to help to face banking crises during the 1990s. Banking crises caused enormous disturbs in emerging countries, in most cases due to the very nature of financial liberalization. Banking crises accelerated, if not determined, the implementation of privatization programs of public-sector banks.

c) In most cases, banking consolidation in emerging markets was of the type "government-driven", that is the government conducted directly or indirectly the process of banking consolidation through programs of banking restructuring, privatization of public banks, flexibility in the rules of foreign bank entry, etc., while in mature markets it was mainly "market-driven" style, that is it was the result of the responses of financial institutions to the policies of financial deregulation and privatization during the 1970s and 1980s.

Banking consolidation in Latin America has been the most advanced among the EMEs. The main "forces of change" of this process were the banking crises that resulted from the 1994 Mexican crisis contagious and the consequent foreign banks entry: "Financial crises and the need to (re-)establish functioning banking systems created a one-time set of opportunities to invest in financial institutions and to expand business in EMEs in the second half of the 1990s. A standard response to crises by EME government, encouraged by the international financial institutions, was to accelerate financial liberalization and to recapitalize banks with the help of foreign investors. This was the case in Latin America in the years following the 1994 Mexican crisis". (CGFS, 2004, p. 6.)

Therefore, there was an active government role in the conduction of banking consolidation in Latin America after the Mexican crisis, although

[6] According to Hawkins and Mihaljek (2001, p. 24), in central Europe, the share of foreign banks in terms of both total of assets and capital is now around two thirds or higher, making these countries' banking systems among the most open in the world, while in Latin America, the market share of foreign banks rose from an average of 7 percent in the beginning of the 1990s to 40 percent in 2000.

[7] See, in this connection, Dymski (1999), and Santomero and Eckles (2000).

since late-1990s this process has been increasingly market-driven. Note that in Latin America, contrasting with the main countries in Asia and Central Europe, the reduction in the quantity of banking institutions was followed by a remarked increasing in banking concentration (excepted Venezuela), according to table 1.

TABLE **1**
Banking concentration in some selected emerging countries

Countries	1994 Market share-total of deposits (%)				2000 Market share-total of deposits (%)			
	Banks quantity (1994)	*Three major banks*	*Ten major banks*	*HH Index (1994)*	*Banks quantity (2000)*	*Three major banks*	*Ten major banks*	*HH Index (2000)*
Asia								
Korea	30	52.8	86.9	1263.6	13	43.5	77.7	899.7
Malaysia	25	44.7	78.3	918.9	10	43.4	82.2	1 005.1
Philippines	41	39.0	80.3	819.7	27	39.6	73.3	789.9
Thailand	15	47.5	83.5	1 031.7	13	41.7	79.4	854.4
Latin America								
Argentina	206	39.1	73.1	756.9	113	39.8	80.7	865.7
Brazil	245	49.9	78.8	1 220.9	193	55.2	85.6	1 278.6
Chile	37	39.5	79.1	830.4	29	39.5	82.0	857.9
Mexico	36	48.3	80.8	1 005.4	23	56.3	94.5	1 360.5
Venezuela	43	43.9	78.6	979.2	42	46.7	75.7	923.1
Central Europe								
Czech Republic	55	72.0	97.0	2 101.5	42	69.7	90.3	1 757.8
Hungary	40	57.9	84.7	1 578.8	39	51.5	80.7	1 241.2
Poland	82	52.8	86.9	1 263.6	77	43.5	77.7	899.7

Source: IMF (2000, p. 127).

Overall, the share of bank assets held by foreign banks in EMEs has increased considerably since 1990. Foreign ownership of the banking sector is substantially higher in Latin America and central and eastern Europe than in Asia. (table 2) While in central and Eastern Europe foreign banks now control more than 60 percent of total banking assets, in the major countries of Latin America, except Brazil, the share of assets owned by foreign banks is more than 30 percent. In Mexico and Argentina the market share of foreign banks (in terms of total assets) was 48 percent and 82 percent in 2004, respectively.

TABLE **2**
Share of bank assets held by foreign banks [1]

Countries	*1990*	*2004* [2]	*In per cent of GDP*	*In billions of USD*
Central and Eastern Europe				
Bulgaria	0	80	49	13
Czech Republic	10	96	92	99
Estonia	—	97	89	11
Hungary	10	83	67	68
Poland	3	68	43	105
Emerging Asia				
China	0	2	4	71
Hong Kong	89	72	344	570
India	5	8	6	36
Korea	4	8	10	65
Malaysia	—	18	27	32
Singapore	89	76	148	159
Thailand	5	18	20	32
Latin America				
Argentina	10	48	20	31
Brazil	6	27	18	107
Chile	19	42	37	35
Mexico	2	82	51	342
Peru	4	46	14	11
Venezuela	1	34	9	9

Notes: 1/ Percentage share of total bank assets. 2/ Or latest available year.
Source: Domanski (2005, p. 72), based on data from ECB and national central banks.

Following the increase of the market share, the range of foreign bank activity in EMEs has broadened a great deal recently. Historically, foreign banks focused primarily on the provision of financial services to their home-country clients in international transactions. However, since the 1990s, foreign investments have increasingly been driven by more general profit opportunities in local markets. Indeed, the present strategy of global universal banks is aimed at diversifying their activities into some domestic markets through a network of branches and greater integration into the local market, while in the past bank's strategies were geared mainly to serving their home-country customers and also giving some support to domestic firms to access the international financial market.[8]

Latin America received one of the biggest influxes of foreign direct investment (FDI) in the banking sector since the middle of the 1990s. However, one cannot understand the wave of bank FDI isolated from the general movement of FDI to Latin America during the 1990s. Indeed, the Latin America and Caribbean region received record levels of FDI in the 1990s, with inflows totaling US$76.7 billion only in 1998, an amount that corresponded to around 41 percent of total FDI flows to developing countries. (ECLAC, 2000, p. 35-36) The majority of FDI flows in financial sector went to Latin America as well. Between 1991 and 2005, transactions targeting banks in the region accounted for US$58 billion or 48 percent of total cross-border M&As targeting banks in EMEs, followed by emerging Asia with US$43 billion (36 percent of total M&As) and central and Eastern Europe with US$20 billion (17 percent of total M&As).[9]

In 1991-2005, the majority of FDI in banking sector to Latin America came from European countries: 46.6 percent from Spain, 10.0 percent from United Kingdom, and 6.4 percent from Netherlands[10] (Domanski, 2005, p. 75). Some of the main determinants of the expansion of European banks in Latin America can be summarized as follows:

[8] See more in Focarelli and Pozzolo (2000).

[9] According to Domanski (2005, p. 70-71) with data extracted from Thompson Financial.

[10] US accounted for 26.5 percent and Canada for 3.6%.

- The process of restructuring of the banking sector under European Economic and Monetary Union (EMU). For some European banks expanding abroad is not only a source of earnings diversification, but also a way of strengthening their position in European banking market considering the increasing market competition in banking in the European Economic Area. The European bank's strategy for Latin America may be interpreted as a response to this more competitive environment, in which several factors were eroding income from traditional banking business.[11] Further, due to political and regulatory constraints, there are some impediments to M&As within EU countries, but incentives to such activity outside the bloc.[12] The preference for Latin America, and to a lesser degree Central and Eastern Europe, is partially due to the fact that Southeast Asia during the second-half of 1990s was in crisis, while the Indian and Chinese financial system remained closed to foreign banks, leaving Argentina, Brazil and Mexico as the main big emerging markets open to FDI in bank sector.
- In particular, the dynamics of the internationalization of the Spanish banks since they were the main protagonists in the recent wave of foreign banks entering Latin America. These banks pursued growth strategies based on M&As in their natural market before they launched their international growth strategy. So, they already were mature banks when they decided to expand overseas. Indeed, with the implementation of EMU and the perspective of introduction of the euro, the larger Spanish banks –in particular, Banco Bilbao Vizcaya (BBV), Banco Santander and Banco Central Hispanico (BCH)– had to look beyond their natural borders in search of global markets, in order to maintain their competitive position and to defend themselves from the threat of hostile bids by either local and foreign competitors. At the initial stages of this process there was a proliferation of alliances and co-operation agreements with other financial institutions, chiefly within the European Union, while the second phase has involved a fast-paced, aggressive expansion strategy aimed at the main Latin American markets.[13]

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11 This hypothesis is developed by Paula (2002).

12 One of these incentives is the absence of a single regulatory agency in the European Union. This has limited the benefits of expanding areas of activity across borders and, at the same time, prevented European banks from engaging in the diversification of earnings and reduction in the regulatory capital, practiced in the US. Although the Single Market Act and the various European commission financial directives should have created some uniformity, difficulties have arisen and hampered cross-border operations. There are multiple supervisory agencies within European countries and no co-ordination agency or single bank regulatory body for the entire euro area. As a result, M&As remain to a greater extent confined within national borders. See more in Kregel (2002).

13 For an analysis of the expansion strategy of Spanish banks to Latin America, see ECLAC (2000, Ch. 3) and Sebastian and Hernansanz (2000).

- The deregulation process in Latin America, in the broader context of economic and political reforms, since early 1990s, made room for the entry of foreign companies into key economic sectors, such as banking, telecommunications and utilities. Bank privatization programs in general formed part of longer-term public sector reforms, which also involved privatization of major public enterprises with the aim of consolidating the public finances and cutting borrowing requirements (Hawkins and Mihaljek, 2001, p. 13). Further, deepening the role of the market was also a major motive.
- The Latin American banking sector offers much better prospects for increasing returns to financial institutions, since the intermediation margins with which banks operate in these countries are considerably higher than in the developed world. While the domestic banks' average margin on assets (net interest income over total assets) in Latin America was 5.76 percent for the period 1988-1995 (in Brazil it was 6.6 percent and Argentina 9.9 percent), in OECD's countries it was 2.80 percent for the same period (Claessens *et al.*, 2001). On the other hand, Latin American banks steadily improved their already high profitability during the 1990s, although net interest revenue has been stable. Their profitability is high both compared to G3's countries and other EMEs.[14]
- The potential gains in efficiency are high in Latin America, since the degree of banking efficiency is in general lower than that in developed countries. The domestic banks' ratio of operating costs to assets in Latin America was on average 5.5% in 1992-1997, while it was 1.7% in G3's countries (US, Japan and Germany), 1.6% in East Asia and 4.1% in Central Europe, in the same period, (Hawkins and Mihaljek, 2001, p. 6) The high operating cost (as well as high interest rate spreads) of domestic banks in Latin America are in large part the legacy of the high-inflation period of the 1980s and the early 1990s, when inflationary revenues generated easy profits for the banks and, consequently, there was little pressure to cut costs.

DETERMINANTS AND SOME FEATURES OF FOREIGN BANK ENTRY IN ARGENTINA AND BRAZIL

The recent process of banking consolidation in Argentina is somehow similar to the Brazilian experience in the sense that in both countries the authorities responded to the banking crisis caused by the effects of the contagious of

[14] Pre-tax profits as percentage of total assets in 1992-1997 was 1.4 on average in Latin America, while it was 0.7 in G3, 0.8 in East Asia, and 0.5 in Central Europe (Hawkins and Mihaljek, 2001, p. 6).

1994-1995 Mexican crisis with an array of support programs for financial institutions and their borrowers. These programs intended to bolster the health of the financial sector and, at the same time, to open the sector to foreign banks, since the presence of these banks could help to strengthen the banking sector.[15] Besides, the entry of foreign banks was used as a policy to weaken the effect of local monopolies that had been established under the previous regulatory structure.

Both countries had important structural changes in their financial systems during the 1990s, evidenced by some decline in the market share of state-owner banks, a decrease in the quantity of financial institutions, including banks, and an increase in banking concentration. In Argentina 1980s high inflation period caused shrinkage in the quantity of banking and non-banking financial institutions probably due to the deep process of economy's demonetization. More recently, after the 1995 banking crisis, there was a huge decrease in the quantity of both public (provincial and municipal ones) and private banks that was followed by a quick increase in the banking concentration: top 10 banks increased from 50.6 percent in December 1994 to 77.7 percent of total of assets in December 2002, a significant increase of more than 50 percent in banking concentration in just nine years (see table 3 and 5). In Brazil, banking consolidation, although less intensive than in Argentina, accelerated a great deal after 1995: Quantity of banks (multiple and commercial ones) declined from 240 banks in December 1995 to 166 banks in December 2002 (table 4) while the market share of top 10 banks (as percentage of total assets) increased from 63.4 percent in December 1995 to 75.7 percent in December 2002 (table 6). These changes in the banking sector in Argentina and Brazil can be attributed to some basic factors, such as banking restructuring policy, programs of banking privatization and the foreign bank entry, following some general trends of banking consolidation in EMEs, as we have seen in the former section.

[15] See Dages *et al.* (2000) for an analysis on the recent foreign bank penetration in and Argentina, and Paula (2002) for Brazilian case.

TABLE 3
Financial institutions and branches in Argentina, 1980-2001

Banks	December 1980		December 1991		December 1994		December 1996		December 2001	
	Institution	*Branches*	*Institution*	*Branches*	*Institution*	*Branches*	*Institution*	*Branches*	*Institution*	*Branches*
National public-sector	4	695	6	931	6	907	3	553	2	614
Provincial public-sector	31	1 145	29	916	27	752	18	920	11	777
Municipal public-sector	35	n.a.	35	1 847	33	1 659	21	1 473	13	1 391
Private-sector domestic	n.a.	n.a.	57	1 090	66	1 198	53	1 807	32	742
Foreign-controlled	27	215	31	322	31	360	39	375	39	1 831
Cooperatives	n.a.	n.a.	44	799	38	842	6	350	2	236
Total of private banks	179	1 999	132	2 211	135	2 400	98	2 532	73	2 809
Total of banking sector	214	n.d.	167	4 058	168	4 059	119	4 005	86	4 200
Non-banking institutions	255	280	47	28	37	22	26	44	22	73
Total of financial system	469	n.a.	214	4 086	205	4 081	145	4 049	108	4 273

Source: Central Bank of Argentina, in Fanelli (2003, p. 50).

TABLE 4
Quantity of financial institutions operating into the Brazilian Financial System

Financial institutions	*Dec-93*	*Dec-94*	*Dec-95*	*Dec-96*	*Dec-97*	*Dec-98*	*Dec-99*	*Dec-00*	*Dec-01*	*Dec-02*
Multiple Banks	206	210	205	191	179	173	168	163	153	143
Commercial Banks	35	34	35	38	36	28	25	28	28	23
Development Banks	7	6	6	6	6	6	5	5	4	4
Investment Banks	17	17	17	23	22	22	21	19	20	23
Finance Companies	41	41	42	47	48	42	41	42	39	46
Securities Brokers	285	280	271	255	237	228	192	186	177	160
Securities Dealers	378	367	323	281	235	207	186	173	156	149
Leasing companies	67	72	78	74	78	80	79	77	71	65
Caixas Econômicas*	2	2	2	2	2	2	1	1	1	1
S&Ls Association/ Mortgage Societies	27	27	23	22	22	21	19	18	18	18
Mortgage Companies	—	—	—	3	3	4	6	7	7	6
Total	1 065	1 056	1 002	942	868	813	743	719	674	638

*/ "Caixas Econômicas" are public banks (federal or state ones) that combine commercial activities with housing finance activities.
Source: Central Bank of Brazil, Financial System Organization Department.

TABLE 5
Banking concentration in Argentina (as percentage of banking assets)

End of :	*Top 5*	*Top 10*	*Top 15*	*Top 20*	*Others*	*Number of Banks*
December 1993	38.19	51.28	59.73	65.71	34.29	167
December 1994	36.43	50.57	58.83	64.89	35.11	168
December 1995	39.88	55.18	64.00	69.29	30.71	127
December 1996	38.71	55.67	66.37	72.38	27.62	120
December 1997	40.89	57.73	67.64	74.05	25.95	113
December 1998	42.82	64.03	73.56	80.03	19.97	104
December 1999	45.64	68.20	77.44	83.23	16.77	92
December 2000	45.63	69.35	79.00	85.09	14.91	89
December 2001	48.71	70.90	80.97	87.01	12.99	85
December 2002	57.16	77.72	86.10	90.38	9.62	78

Source: Association of Banks of Argentina (ABA), with data from the Central Bank of Argentina.

TABLE 6
Banking concentration in Brazil (as percentage of total assets)

Period	*Semester*	*Top 2*	*Top 5*	*Top 10*	*Top 20*
1994	I	33.38	48.45	63.37	75.86
	II	33.41	49.91	62.82	75.70
1995	I	29.57	48.14	62.54	75.44
	II	30.46	50.44	63.39	75.34
1996	I	27.50	48.28	60.30	72.12
	II	29.14	50.95	62.73	75.56
1997	I	29.13	50.51	62.12	76.67
	II	30.76	51.46	63.74	78.77
1998	I	32.02	51.86	64.63	78.48
	II	34.64	55.81	69.77	83.31
1999	I	33.77	55.75	68.99	82.11
	II	33.03	54.72	69.27	83.30
2000	I	32.49	53.91	69.48	84.44
	II	31.17	57.09	74.58	88.22
2001	I	26.02	52.35	71.73	86.77
	II	27.08	53.19	71.84	86.38
2002	I	26.11	57.72	72.89	87.21
	II	28.88	57.96	75.74	89.09

Source: Rocha (2001) until 2000; authors' calculations for 2001-2002, both with data from Central Bank of Brazil.

However, there are some differences and particular features when ones analysis the recent Argentine and Brazilian experiences related to foreign bank penetration.

Firstly, financial liberalization was more intensive in Argentina than in Brazil. Financial liberalization in Argentina followed the implementation the Convertibility Plan.[16] Actually, currency board system required financial liberalization as a way to assure a high and stable influx of external capital in order to sustain an adequate level of liquidity in the domestic financial system. Therefore, between 1989 and 1994, almost all the regulatory controls on domestic and external operations in the financial system, that had been replaced during the 1980s due to the high inflation and external constraints, were lifted (Hermann, 2001). Within this new context, foreign banks had full freedom to issue deposits and to extend credit in foreign currency (that is, dollar), to get resources abroad, and to issue subordinated debt in external financial markets. Indeed, prudential regulations stimulated a strong and quick increase in dollarization in Argentina during the 1990s. In Brazil financial liberalization was slower and more restrictive compared to Argentina: during the 1990s only the investments of institutional investors in assets negotiated in Brazil were partially liberalized (Annex IV and V of Central Bank of Brazil), although non-resident accounts in foreign markets (CC5) had been used very often by residents –mainly financial institutions– to send dollars abroad during turbulent periods of speculative attach on the Brazilian currency –the real–.[17] After the 1999 Brazilian

[16] Under the new monetary regime –currency board– the monetary authority was committed to back all monetary liabilities with international reserves and to be ready to exchange one peso for one dollar when requested to do so. Thus, the central bank gave up monetary policy, as money supply became entirely endogenous. The new monetary regime was followed by some constraints aimed to enhancing its credibility: (i) the central bank became independent; (ii) the peso-US dollar exchange was set by law; (iii) the foreign exchange rate market was fully liberalized; (iii) central bank was restrained from financing any fiscal deficit, except through the purchase of government bonds at market prices; (iv) all the contracts could be denominated in dollars, but the law prohibited the inclusion of indexation clauses to avoid inflation inertia; (v) free capital mobility was established. (Kiguel, 2001, p. 23-4).

[17] See more, in this regard, Paula *et al.* (2003).

currency crisis and the adoption of a floating exchange regime, economic authorities implemented a lot of norms that resulted in greater flexibility in exchange rate market, including the unification of the exchange rate markets (floating and free ones), simplification of the procedures related to the capital remittance to other countries, and extension of maturities for exchange rate coverage related to exports operations.

Secondly, foreign bank opening up was much deeper in Argentina than in Brazil during the 1990s. Indeed, while Menem's government lifted all the restrictions concerning the presence of foreign banks in the Argentine financial system, in Brazil Cardoso's government was more selective in terms of foreign bank entry. Legislative Intent no. 311, from 23/08/1995, an act from the Brazilian's President, allowed the President exceptionally to authorize, case to case, the entrance of foreign banks in Brazil. In that occasion, Brazilian government announced that foreign banks would not be allowed to open new branches or acquire smaller banks unless they purchased one of the troubled state-owned banks. Although 1988 Brazilian Constitution prohibited the installation, in the country, of new branches of financial institutions domiciled abroad, until a new comprehensive law governing the financial sector could be developed, it also opened a chance to foreign banks entry through authorizations resulting from international agreements, from reciprocity or from interest of the Brazilian government. Within this legal context, foreign banks entry in Brazil was approved on a case-by-case basis, mainly to recapitalize troubled banks. The increase of foreign participation in Argentine banking market was deliberated promoted by a restructuring and concentration policy implemented after the contagion of the Mexico's Tequila crisis, that severely tested the Convertibility system and the financial sector –sparking an outflow of almost 20 percent of system deposits–.[18] During the Tequila crisis, efforts were undertaken to reestablish confidence in the banking sector that "included the introduction of deposit

[18] According to Kiguel (2001, p. 7-8), the Argentine financial system suffered a sudden loss of near 18 percent of total deposits in only four months, and international reserves fell by $6 billion (or 33 percent) between December 1994 and March 1995.

insurance, a renewed commitment to privatizing inefficient public sector banks, the liquidation or consolidation of nonviable entities, and the dedication of substantial resources to strengthening supervisory oversight and the regulatory framework. Within this context, foreign banks were permitted to play an important role in recapitalizing the Argentine banking system" (Dages *et al.*, 2000, p. 21).

In Argentina and Brazil, capital requirements were stricter than those imposed by the Basel Committee: The capital asset rate was set at 11.4 percent in Argentina and 11.0 percent in Brazil during the 1990s as opposed to the 8 percent level recommended by the Basil Committee. In both countries foreign bank entry was justified by the necessity of strengthening the financial system and also to incorporate criteria and international experiences of banking supervision in the domestic financial system. In Argentina, however, one further reason highlighted by monetary authorities was the bigger facility to access external capitals by the domestic financial system, since this was considered essential to the *modus operandi* of convertibility regime. Indeed, foreign banks in Argentina had, *ceteris paribus*, an important role in maintaining the capital inflow to the country in regular levels and also to provide a contingent credit line to central bank in the event of a crisis.[19]

Thirdly, Argentine financial system weakened a great deal during the 1980s high inflation period, as a result of both process of demonetization and financial desintermediation, while the Brazilian financial system strengthened during the high inflation period, due to the development of a broader domestically-denominated indexed money and also the increasing

[19] The main objective of PCP (Programa Contigente de Pases) –a contingent credit line from foreign banks to the Central Bank of Argentina– was "to ensure access to foreign currency in the event of a crisis in order to back the issuance of domestic currency and hence fulfil the central banks's role of lender of last resort. This facility gives the monetary authority the option to conduct repurchase (repo) operations by selling Argentine public bonds denominated in US dollars and receiving the proceeds in dollars. This option enables the Central Bank to obtain dollars and hence to expand domestic credit, using the borrowed reserves to back the monetary expansion without violating the convertibility law". (Kiguel, 2001, p. 12).

development of a modern clearing system in the banking sector in order to support the clients' demand for immediate information and the clearing of checks. Consequently, the decreasing in M1 (cash plus deposit deposits) did not result in lost of funds to the Brazilian financial system. In Argentina, in turn, there was a deep process of dollarization that was followed by an enormous decrease in financial deepening. Informal dollarization in Argentina began since the first and not-well succeeded experience of financial liberalization in 1977-1982.[20]

During the 1994-1995 Mexican crisis, Brazilian banking sector faced a liquidity crisis that did not result in a systemic crisis, due to the liquidity provision to banking sector by Central Bank of Brazil and the successful implementation of PROER, the Program to Support the Restructuring and Strengthening of the National Financial System. This program aimed to preserve the solvency of the financial system by removing distressed banks and bolstering those that remained.[21] In Argentina, due to the lack of adequate mechanisms for provision of liquidity for banking sector, as Central Bank of Argentina faced constraints to act as lender of last resort, the contagion of Mexican crisis had a huge impact on the healthy of financial system. Consequently, financial liberalization (including foreign bank entry) found domestic banks very bad capitalized, with difficulties to attract deposits and to borrow in both domestic and international financial markets. These structural features of Argentine and Brazilian financial system explain, at least partly, the much better reaction of Brazilian private domestic banks to the foreign bank entry compared to the Argentine ones.

[20] According to Bresser-Pereira and Ferrer (1991, p. 10), in Argentina both M1 and M4 (that also include financial assets) decreased since end of the 1970s. In February 1990 M1 was less than 3 percent of GDP, while M4 as less than 5 percent of GDP, as a result of portfolio re-allocation to dollar.

[21] According to the International Focus of EconSouth (Third Quarter 2001), "another notable feature of the Brazilian banking system is that it did not experience the sort of devastating banking crises suffered by many other countries during the 1990s. Serious problems were clearly evident in some Brazil's bank by the end of 1994, but the magnitude of these problems did not pose a threat to the banking system as a whole".

Finally, it is worth to note that while the main acquirers of banks in Argentina during the 1990s were foreigners, private domestic banks commanded the banking M&As wave in Brazil.[22] In both countries prevailed European banks as the main players among the foreign banks: in Argentina, the biggest foreign banks are the Spanish Banco Rio de la Plata Santander and Banco Francês BBVA, and the British HSBC Banco Roberts, while in Brazil the major banks are the Spanish Banespa-Santander, the Dutch ABN Amro Real and the British HSBC. In Argentina foreign bank entry occurred mainly via the acquisition of existing operations: foreign shareholders acquired stakes in private institutions with a national or regional franchise (for instance, privatized provincial and municipal banks). Such acquisitions accelerated a great deal in the beginning of 1996, with foreign banks acquiring controlling stakes in a majority of Argentina's largest private banks. In Brazil, such as in Argentina, foreign bank entry occurred initially via the acquisition of some troubled banks (Bamerindus, for instance). Increasingly, bank take-overs embraced a strong bidder and sometimes a weak, but not yet insolvent, target, such as the acquisition of Noroeste by Santander and Real by ABN Amro. Unlike Argentina, where foreign bank acquisitions included two of the largest three private banks (that is, Banco Rio de la Plata, and Banco Francês), foreign acquisitions in Brazil involved mainly medium-sized banks, such as Excel-Econômico and Banco Geral do Comércio (the exception was the acquisition of Banespa by Santander).

EFFECTS OF FOREIGN BANK ENTRY IN ARGENTINA AND BRAZIL

In this section we compare the effects of foreign bank entry in Argentina and Brazil, highlighting some common features as well as the differences of each one.

In Argentina and Brazil, as a result of the recent foreign bank penetration, there was a dramatic expansion of foreign control in the domestic banking

[22] See more in this connection in the next section.

sector market share. In Argentina foreign control over deposits and loans increased from 16.1 percent and 16.2 percent, respectively, in November 1994 to 51.8 percent and 48.4 percent, in December 2001, at the costs of the decline of the market share of both provincial-municipal banks, domestic private banks and cooperative banks (table 7). In Brazil foreign control over deposits and assets increased from 4.4 percent and 9.8 percent, respectively, in December 1996 to 19.8 percent and 27.4 percent in December 2001, at the costs of the decline of the market share of state-public banks and federal-public banks[23] (table 8).

TABLE 7
Market share in the Argentina's banking sector
(percentage)

Financial institutions	Nov-1994		Dec-1996		Dec-2001	
	Deposits	*Loans*	*Deposits*	*Loans*	*Deposits*	*Loans*
National-public banks	14.5	18.1	13.5	18.9	16.0	14.3
Provincial and municipal banks	24.3	23.5	22.3	17.3	16.8	14.7
Total of public sector	38.8	41.6	35.8	36.2	32.8	29.0
Private-sector domestic	33.4	32.4	22.7	19.7	12.7	18.4
Foreign-controlled banks	16.1	16.2	38.5	41.0	51.8	48.4
Cooperative banks	10.4	8.2	2.3	1.8	2.3	2.1
Total of private banks	59.9	56.8	63.5	62.5	66.8	69.9
Total of banking sector	98.7	98.4	99.3	98.7	99.6	97.9
Non-bank institutions	1.3	1.6	0.7	1.3	0.4	20.1

Source: Central Bank of Argentina, in Fanelli (2003, p. 52).

[23] The two big federal-public banks, Banco do Brasil and Caixa Econômica Federal (CEF), although have reduced their market share in the Brazilian banking sector, from 38 percent in December 1993 to 29 percent in December 2002 (as percentage of total assets), they are still the leaders of the sector. One should consider that they were prohibited to take part of the recent wave of banking M&As in Brazil.

TABLE 8
Market share in the Brazilian banking sector

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	As percentage of total deposits (%)									
Foreign-controlled banks	4.83	4.58	5.40	4.36	7.54	15.14	16.80	21.14	20.14	19.82
Private-sector domestic banks	38.80	39.35	36.40	34.06	32.85	33.08	31.82	33.93	35.33	36.60
Public-sector banks*	17.25	16.45	16.07	18.66	17.09	13.26	11.54	7.36	7.15	7.41
Caixa Econômica Federal	27.92	24.35	24.33	26.58	24.05	20.52	19.91	19.49	19.09	16.92
Banco do Brasil	11.08	15.11	17.59	16.00	18.00	17.41	19.14	17.05	16.98	17.73
Credit cooperatives	0.12	0.16	0.21	0.34	0.47	0.59	0.79	1.03	1.31	1.52
Banking sector	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
	As percentage of total assets (%)									
Foreign-controlled banks	8.35	7.16	8.39	9.79	12.82	18.38	23.19	27.41	29.86	27.38
Private-sector domestic banks	40.67	41.21	39.16	39.00	36.76	35.29	33.11	35.23	37.21	36.93
Public-sector banks*	13.41	18.17	21.90	21.92	19.06	11.37	10.23	5.62	4.3	5.87
Caixa Econômica Federal	14.51	14.98	16.40	16.47	16.57	17.02	17.06	15.35	10.97	11.66
Banco do Brasil	22.93	18.28	13.91	12.52	14.42	17.44	15.75	15.63	16.76	17.12
Credit cooperatives	0.13	0.20	0.24	0.30	0.37	0.50	0.66	0.76	0.9	1.04
Banking sector	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

*/ Mainly state-public banks; data excludes the two big federal banks. Caixa Economica Federal and Banco do Brasil.
Source: Central Bank of Brazil.

Comparing Argentina and Brazil's experiences, the most obvious feature is that, after the wave of foreign bank penetration of mid-1990s, foreign banks in Argentina dominate the banking sector *vis-à-vis* domestic private banks, while in Brazil domestic private banks still dominate the banking sector. In Argentina, among the top 10 banks, seven banks were foreign ones, two banks were public banks –the bank leaders, Banco de la Nación Argentina (federal) and the Banco de la Província de Buenos Aires (provincial)– and only one bank was domestic private bank (Banco de Galicia y Buenos Aires), according to data from 2000. In turn, in Brazil (data from 2000), among the top 10 banks, four banks were foreign, four banks were domestic private, and two were federal ones (the leaders, Banco do Brasil and Caixa Econômica Federal). In terms of total deposits of banking sector, foreign-controlled banks had in Argentina 51.8 percent of total banking sector assets in 2001, while private-sector domestic banks had only 12.7 percent (public-sector banks had 32.8 percent of total of assets). Therefore, roughly half of all banking sector deposits in Argentina were under foreign control, with foreign shareholder holding significant minority stakes in a number of other financial institutions. In Brazil, foreign banks had 20.1 percent of total deposits in 2001, while domestic private banks had 35.3 percent and public-sector banks (including Banco do Brasil and Caixa Econômica Federal) had 26.2 percent. Considering only the top 12 private-sector banks, the five major domestic private-sector banks (Bradesco, Itau, Unibanco, Safra and BBA) had 28.8 percentage of total assets of private-sector in 2001, while the seven biggest foreign banks had 21.2 percentage (Paula, 2003, p. 170).

One should consider that in Argentina foreign entities already operating in the country had a more solid situation than domestic ones, that had been very weakened due to effects of Mexican crisis, as foreign banks had better conditions to access funds abroad. Thus, 1990s financial aperture found many domestic private banks very few capitalized and with difficulties to attract deposits. Furthermore, as we have already stressed, Menem government lifted all the restrictions concerning the presence of foreign banks in Argentine financial system, what meant that domestic banks faced foreign banks' competition in a moment that they were much weakened.

In the case of Brazil, domestic private banks reacted positively to foreign bank penetration, improving their efficiency, obtaining revenue economies through cross-selling activities and at the same time expanding their activities organically or by mergers and acquisitions.[24] Doing so, they maintained their hegemony in the domestic banking sector. According to Paula (2002, p. 87), "domestic private banks have some advantages over foreign banks which they can exploit, since they are more adapted to the peculiarities of the Brazilian banking market. Their active reaction to foreign bank entry, cultural differences and high level of development and sophistication of the banking sector in Brazil, which resulted from its ability to adapt to the period of high inflation, may explain this behavior".

In sum, in Brazil there was a banking restructuring that resulted only in a partial denationalization of banking sector, with no dollarization. The most distinguished feature of the Brazilian experience was the reaction of the domestic private banks to foreign bank entry. In Argentina, financial liberalization resulted in the dominance of foreign banks that was accompanied by an increasing dollarization of banking sector.

In broader terms, in both countries there was no significant difference in the behavior of foreign banks compared to the domestic private banks, as they tended to adapt the macro-institutional environment in the same way of the latter ones. According to Dages *et al.* (2000, p. 24), domestic and foreign private banks exhibit in 1994-1999 in Argentina "comparable loan behavior, coexist in the distribution of larger and smaller banks within the top twenty-five banks nationally, and have loan portfolios of similar compositions. The banks respond similarly to market signs, including real GDP (Gross Domestic Product) growth and real interest rates", although they also "appear to have provided greater loan growth than what was observed among domestic-owned banks, while reducing the volatility of loan growth for the financial system as a whole". Table 9 shows that the composition of

[24] One of the reasons of the reaction of domestic banks in Brazil is that the severity of 1994-95 crisis was relatively low compared to Argentina (and also Mexico), and Central Bank of Brazil could act rapidly in order to avoid that a banking distress could result in a systemic risk.

bank portfolio –in terms of loans– in Argentina in 1994-1999 were very similar for domestically owned banks and foreign owned banks. Foreign banks generally engage in the same types of broad lending activities as domestic banks. Furthermore, banks in general have concentrated their loans in big debtors, with the exception of the cooperatives banks (table 10). In particular, banks with foreign control provided only 34 percent of their credit portfolio for loans less than 200 000 pesos (Argentina's currency) in December 2002, while domestic private banks destined 42 percent for this category of loans. These data show some evidence that foreign bank entry can have resulted in an increase of the credit discrimination for borrowers with lower income.

Table **9**
Composition of banking portfolio by ownership in Argentina
(as percentage of total loans)

Type of loan	Domestically owned banks						Foreign-controlled banks		
	State-owned			*Privately owned*					
	1994	1997	1999	1994	1997	1999	1994	1997	1999
Personal	5.2	5.8	5.9	13.2	10.4	6.1	14.1	13.3	5.5
Mortgage	32.1	32.2	35.1	9.4	13.2	15.0	11.0	11.7	14.7
Commercial, government, and other	62.7	62.0	59.0	77.4	76.4	78.9	74.9	75.0	79.8

Source: Dages, Goldberg and Kinney (2000, p. 22).

TABLE **10**
Loans share by credit size. Argentina, december 2002
(percentage)

Financial institution	*Less than 200 000*	*200 000 to 2 500 000*	*More than 2 500 000*	*Debt (million of pesos)*	*Debt (% of total banks)*
Total	38.7	14.62	47.11	100 770	100
Public sector					
National-public banks	34.08	12.06	53.86	13 927	13.82
Provincial and Municipal	40.39	13.15	46.46	17 089	16.96
Private sector					
Domestic	41.83	16.73	41.44	22 152	21.98
Foreign controlled	33.97	16.07	49.96	30 196	29.97
Foreign participation	42.03	11.01	46.96	15 646	15.53
Cooperative banks	45.61	30.23	24.16	1 759	1.75

Source: Central Bank of Argentina, in Fanelli (2003, p. 49).

Similar behavior of foreign banks has been observed in Brazil, where recent studies have shown that operational characteristics of domestic and foreign banks are similar, as well as the balance sheet structures, dominated by interfinancial operations and by investment in securities, mainly public bonds (Carvalho *et al.*, 2002; Carvalho, 2002). Foreign bank behavior has been even more conservative than domestic private ones in recent period (1998-2002): the total loans as percentage share of total assets has been in general higher in domestic private banks when compared to foreign banks (table 11). Furthermore, the expected credit expansion due to the foreign bank entry did not occurred in Brazil, probably because this entry coincided with the external shocks that Brazilian economic suffered in the last years. Finally, some studies (Guimarães, 2002; Paula, 2002) also show evidences that, contrary to the international literature that states that foreign banks are more efficient than domestic banks in EMEs (Levine, 1996; Demingüç-Kunt and Huizinga, 1998), there is no clear evidence that foreign banks in Brazil

have been more efficient than domestic ones both in terms of operational cost and profitability. Domestic private banks profitability, determined mainly by the evolution of the profitability of the four major domestic private banks (Bradesco, Itaú, Unibanco and Safra), proved greater and more stable than foreign banks profitability during 1998-2002, while foreign banks' net interest margins have proved larger than those of the domestic private ones (table 12). Therefore, increased competition due to the recent entry of foreign banks has thus not brought about, at least in the recent years, the decline in the net interest margin which one might have expected according to the literature (Claessens *et al.*, 2001).

Table **11**
Banks portfolio in Brazil
(as percentage share of total assets)

End-of-period	Total loans on total assets [1]				Total securities on total assets [2]			
	Total	*FB*	*DP*	*FE*	*Total*	*FB*	*DP*	*FE*
June 1998	41.8	55.1	39.9	39.5	36.5	24.3	34.6	37.3
Dec 1998 [3]	43.6	55.2	41.2	44.0	31.0	35.9	38.9	36.7
June 1999	43.0	54.0	39.4	42.2	38.2	31.9	35.8	35.1
Dec 1999	44.0	53.5	41.8	42.2	37.9	29.7	36.4	36.6
June 2000	47.1	55.1	45.0	46.7	37.8	30.8	35.1	36.0
Dec 2000	47.8	56.5	47.2	38.4	37.5	26.0	36.0	48.1
June 2001[4]	46.9	46.9	49.7	46.4	37.2	32.7	31.5	39.4
Dec 2001	44.2	37.3	49.9	46.4	43.1	46.0	33.3	43.3
Jun/2002	43.9	42.5	43.1	46.6	42.1	39.8	35.7	41.0
Dec 2002	41.7	33.7	47.4	48.7	43.2	45.8	35.4	38.4

Notes: 1/ Includes other loans besides normal loans. 2/ Includes also interfinancial operations. 3
Excludes ABN Amro because of the incorporation of Banco Real. 4/ Excludes Santander becaus
of the incorporation of Banespa.
DP: 4 major domestic private banks (Bradesco, Itaú, Unibanco and Safra); FE: 6 major foreig
banks (Santander, ABN Amro, BankBoston, HSBC, Citibank and Sudameris); FB: 2 major feder
state-owned banks (Banco do Brasil and CEF); Total: includes all financial conglomerates, publ
and private ones.
Source: Authors' elaboration with data extracted from financial conglomerations i
<www.bcb.gov.br>.

TABLE **12**
Banks Profitability and Net Interest Margin, 1998-2002

End-of-period	Return on Assets (ROA)				Return on Equity (ROE)				Net Interest Margin			
	Total	*FB*	*DP*	*FE*	*Total*	*FB*	*DP*	*FE*	*Total*	*FB*	*DP*	*FE*
June-1998	–0.02	0.25	0.72	0.50	–0.28	5.52	7.95	6.34	1.93	1.39	2.58	3.11
Dec-1998 [1]	0.54	0.27	1.18	0.42	6.84	6.46	11.43	4.75	2.15	1.14	2.55	2.83
June-1999	1.11	0.26	1.16	1.11	13.04	6.41	11.48	11.38	2.67	0.71	2.32	4.94
Dec-1999	0.52	0.22	1.12	0.36	5.81	4.92	10.20	3.57	2.63	1.85	2.67	3.47
June-2000	0.60	0.18	1.21	0.36	7.08	4.32	11.38	4.03	2.35	1.80	2.55	2.28
Dec-2000	0.35	0.32	1.09	0.51	4.15	7.71	10.58	5.24	1.96	1.68	2.28	0.58
June-2001 [2]	0.25	–1.69	1.26	0.98	2.79	–33.03	12.19	10.87	1.78	0.17	2.16	3.21
Dec-2001	0.48	0.18	1.34	0.94	5.24	3.83	12.27	10.12	2.40	1.71	2.89	3.40
June-2002	0.93	0.49	0.91	1.48	10.20	11.29	8.57	14.73	2.52	2.18	1.85	3.44
Dec-2002	0.94	0.52	0.98	1.84	10.75	12.45	10.39	16.54	3.28	2.61	2.31	4.99

Notes: 1/ Data excludes ABN-Amro because of the incorporation of Banco Real.
2/ Data excludes Santander because of the incorporation of Banespa.
DP: 4 major domestic private banks(Bradesco, Itaú, Unibanco and Safra); FE: 6 major foreign banks (Santander, ABN-Amro, BankBoston, HSBC, Citibank and Sudameris); FB: 2 major federal state-owned banks (Banco do Brasil and CEF);
Total: includes all financial conglomerates, public and private ones.
Source: Authors' elaboration with data extracted from the financial conglomerations in Central Bank of Brazil.

In both countries, unstable macroeconomic environment during the 1980s and 1990s impeded the development of credit relationship in the domestic economy, at the same time that this environment determined the behavior of the banks, including the foreign ones (Fanelli, 2003; Paula and Alves Jr., 2003). The Brazilian financial sector is large and bank-dominated, but the extent of intermediation –the ratio of intermediate financial flows resulting from the collection of deposits to the amount of credit actually extended– is small. Brazilian banking sector seems very large when compared to those in other advanced Latin American economies (Mexico and Argentina), at the same time as it provides about the same proportion of loans as banks in these countries. On the other hand, in terms of asset size to GDP, the Brazilian banking sector compares to the US banking sector, but provides only half the loans in proportion to GDP (table 13). Although Brazil has one of the most sophisticated banking sector of the world in terms of technology and clearing system, the ratio total credit-to-GDP was only 24.8 percent in 2000, which is very low compared to developed countries. Furthermore, the Brazilian bond and equity markets are still in their infancy compared with those in more advanced countries: At end-2000, equity finance through stock market issues represented 35 percent of GDP in Brazil, about one-quarter the level in the US. In turn, Argentine financial sector is only partially bank-dominated. Its bond and equity markets are larger than Brazilian ones –equity finance through stock market issues represented 58.2 percent of GDP in Argentina– but still very small when compared to advanced countries. Such as Brazil, the ratio of total credit-to-GDP in Argentina was very low, that is only 21.4 percent in 2000. On the other hand, in terms of asset size of financial system to GDP, Argentina and Brazil have less than half of US ones. In sum, financial deepening of Argentina and Brazil is still very underdeveloped, even after 1990s succeeded years of price stabilization.

In both Argentina and Brazil financial intermediation has been short-termist, although short-termism in Argentina was followed by a high degree of dollarization in the portfolio of financial institutions and in financial contracts. This phenomenon had already begun in 1975 crisis, but it increased a great deal during the 1990s. The maturity of financial contracts

TABLE **13**
Financial system in some selected countries, 2000
(percent of GDP)

Country/Area	Banking system [1]			Stock market capitalization	Total financial assets
	Deposits	*Loans*	*Assets* [4]		
Argentina	27.8	21.4	57.4	58.2	145.5
Brazil	29.3	24.8 [2]	77.1	35.0	161.5
Mexico	18.3	21.6	25.0	22.1	53.4
Chile	54.9	70.0	98.4	86.4	221.6
United States	42.6	45.3	77.3	152.0	376.9
Japan [3]	94.8	84.7	142.0	68.0	338.9
Euro Area	78.9	103.7	258.3	89.0	458.7

Notes: 1/ Only deposit-tanking, universal banks are considered.
2/ Data include commercial leasing.
3/ Bank data for Japan are as of March 2001.
4/ Data include total assets in the banks' balance sheet.
Source: Belaisch (2003, p.4), with data from Central Bank of Brazil, Federal Reserve Bank, ECB, BIS, and Federación Iberoamericana de Bolsas de Valores.

in Argentina had been affected by changes in inflation, macroeconomic volatility and also in the macroeconomic policy regime. The lengthen of the contracts, when it occurred, was slow, and it was often followed by an increase in the dollarization, as the credit operations illustrate. Thus, the preference for flexibility prevailed in the portfolio decisions of financial institutions as well as in the use of short-run as a instrument to reduce the banking risks. Within this context, financial institutions had a big flexibility to change their portfolio investments *vis-à-vis* financial and macroeconomic shocks. In Argentina during the 1990s there was a mismatching of currencies in the balance sheet of banks, due to the predominance of a dollarized liabilities while the assets were partly denominated in domestic currency (*peso*), mainly during the turbulent times when firms sought to change their

long-term debts denominated in dollars by short-term debts denominated in *pesos*. This situation put the banks in a very vulnerable position in case of a sudden increase in the costs to get dollar and of an eventual exchange rate devaluation, that would result in the end of the Convertibility system. Argentine banks, expressing their liquidity preference during the recession that began in 1999, increased their investments in public bonds, as well as their liquidity requirements, and reduced the more risky assets in their portfolio, becoming increasingly submitted to government risk (Fanelli, 2003, p. 41). Due to the high degree of dollarization, an eventual break in the convertibility between peso and dollar would have –as it did have– chaotic and deep effects to the financial system and Argentine economy. Indeed, the default on government debt in December 2001, followed by the devaluation of the peso in January 2002, had devastating consequences for the banking system as a sizable portion of bank assets (by 21 percent in October 2001) was in government liabilities.[25] After 2001 crisis, Argentine banks could not only give back the deposits for their clients, but also they could not pay their own debts.[26]

In Brazil, such as in Argentina, financial intermediation has been short-termist, that is, in both preponderate the preference for flexibility of financial institutions. However, the supply of indexed and/or short term- domestic assets has satisfied the demand for flexibility of the economic agents (firms and households) without the necessity of dollarizing assets and contracts. Exchange rate hedge and interest rate hedge were offered by the government via the issuance of domestic public bonds, indexed to dollar or to overnight

[25] According to Del Negro and Kay (2002, p. 12-13), "In November 2001 the government induced the banks to 'voluntarily' swap government bonds for iliquid government liabilities, prompting large deposit withdrawals: Deposits fell 24 percent by the end of the year. In the final days of the De la Rua government only a freeze on deposits could prevent a widespread bank run. In January 2002 convertibility ended and the peso underwent a large devaluation. By government decree, in February 2002 all dollar-denominated loans were converted at 1.4 pesos per dollar. According to Moody's, the banking system's losses as a result of the crisis could reach $54 billion". For an analysis of the causes of the 2001-2002 Argentina's crisis, see Fanelli (2002).

[26] According to Fanneli (2002, p. 34), the banks' debts in Argentina were by US$14 billion in 2002.

rate. These conditions allowed that the Brazilian banks faced the external shocks in 1997-2002 with a matched and protected balance sheet, that is they facilitate them to combine banking soundness with high profitability.[27]

Finally, there is no evidence in Argentina and Brazil that in the long run foreign bank entry has contributed, by itself, to strengthen the financial system and to avoid balance of payments crises. In Brazil banking soundness has been obtained by the government offer of exchange rate –and interest rate– hedge to the banking sector, as we have already stressed. Besides, the greater flexibility in economic policy has allowed the economy to face the external shocks without a systemic crisis, although at the costs of the huge and quick increase in the public debt.[28] Indeed, public debt over GDP in Brazil increased from 34.1 percent in December 1997 to 57.4 percent in December 2002.[29]

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27 Paula and Alves Jr. (2003, p. 363) state that "One institutional feature of Brazil's economy in the size and composition of its public debt –predominantly indexed bonds. Indeed, macroeconomic imbalances in Brazil have resulted in increasing the domestic public debt–. The financial institutions called for hedges against changes in the interest and exchange rates if they were to buy federal domestic securities. This environment has favoured the adoption of a conservative but profitable stance by the banking sector in Brazil, yielding rich revenues from high-spread short-term credit operations and from government securities. […] The novelty in the Brazilian case is that the banking sector strategy has been able to combine liquidity with profitability due to its current institutional-macroeconomic specificities".

28 In Brazil, the Real Plan (1994-1999) was conceived on the same basis as stabilization programs with exchange anchor that have been applied in Latin America since the late 1980s, using a fixed or semi-fixed rate of exchange in combination with more open trade policy as a price anchor. It differed from Argentina's Convertibility Plan by adopting a more flexible exchange anchor; that is, a typical currency board system, rather than pegging the domestic currency at one-to-one parity with the US dollar. At the outset of the Brazilian program, in July 1994, the government's commitment was to maintain an exchange rate ceiling of one-to-one parity with the dollar. Moreover, the relationship between changes in monetary base and foreign reserve movements was not explicitly stated, allowing some discretionary leeway. After the effects of the Mexican crisis, the exchange rate policy was reviewed and in a context of a crawling exchange rate band the nominal rate began to undergo gradual devaluation. In early 1999, however, after six months of speculative pressure, the *real* was devalued and, some days later, the Brazilian government adopted a floating exchange rate. For a general analysis of the origins and development of the Real Plan, see Ferrari-Filho and Paula (2003).

29 Data from IPEADATA <www.ipeadata.gov.br>.

In Argentina, due to the rigidity of the convertibility system, the survival of this system depended partly of the combination between of foreign bank entry and a broader financial regulation framework. However, the effect of this combination was contradictory: although it resulted in an apparent increase in the financial system soundness, as 1997-1999 external crises showed,[30] it finally contributed to the rupture of convertibility system due to the incentives for the dollarization of the economy. That is, the country depended of the desire and interest of foreign banks to get external funds and to offer resources to Central Bank of Argentina, through a contingent credit line (PCP). As the crisis unraveled, some of the supposed benefits of the international banks –such as the enhancement of the stability of the domestic banking system– did not quite materialize as expected.

As we have already stressed in section 3, prudential regulatory framework in Argentina stimulated the increase of dollarization, as it admitted the constitution of deposits and loans in foreign currency and it facilitated the access of financial institutions to the international financial markets. As a result, as financial regulations increased the degree of Argentina's economy dollarization, they increased the exchange rate risk of the banks. Indeed, monetary authorities did not asked that banks constitute provisions by reserves or bigger capitalization to face the exchange rate risk. Consequently, Argentine banks had no incentive to hedge their positions in foreign currencies (Fanelli, 2003, p. 35-36).

Summing up, Argentina case illustrates that it is very difficult to maintain a sound banking sector with only prudential policies when the economic problems are due to serious macroeconomic unbalances. It also shows that the presence of international banks can be not enough to prevent local banking crises and sizable losses for depositors.

[30] As Del Negro and Kay (2002, p. 12) states: "Before the current crisis, the Argentine banking system was hailed as a success story for Latin America […]: a 1998 World Bank study rated Argentina's regulatory regime among the top three in emerging countries".

CONCLUSION

We can now summarize the main conclusions of this paper:

a) In both Argentina and Brazil the combination between financial liberalization and the framework of the macroeconomic policy (that allowed bigger or shorter flexibility in terms of country's responses to external shocks), plus the degree of development of financial system inherited from high inflation period, was essential to understand the degree of internationalization of financial system and the reaction of the domestic private banks in each country. Financial liberalization, that followed the Convertibility system, was more intensive in Argentina than in Brazil, and it was followed by the acceleration of dollarization of the Argentine economy. This is probably one of the reasons why currency-financial crisis was much more destructive –in economic-social terms– in Argentina than in Brazil.

b) There is no evidence that in the long run foreign bank entry has contributed, by itself, to strengthen significantly the financial system and to avoid balance of payments crises in Argentina and Brazil. Indeed, the greater stability due to the foreign bank presence would be derived by the fact that the branches and subsidiaries of large international banks can draw on their parent for addition funding and capital when needed. In Brazil banking soundness has been obtained by the government offer of exchange rate –and interest rate– hedge to the banking sector at the costs of the weakening of public finance conditions. In Argentina, it was expected that the presence of foreign banks in domestic banking system would enhance the financial system as occurred after the 1995 banking crisis due to Mexican contagion. As the 2001-2002 crisis unraveled, some of the supposed benefits of the international banks –such as the enhancement of the stability of the domestic banking system– did not quite materialize as expected.

c) The experience of foreign bank entry in Argentina and Brazil has evidenced that the penetration of foreign banks in these countries did not contributed effectively to the improvement in the macroeconomic efficiency of financial system.[31] The reality of these countries shows that the unstable macroeconomic environment is

[31] In the same connection, Moguillansky, Studart and Vergara (2004, pp. 32-33), analyzing the behavior of foreign banks in the seven biggest Latin America's countries, conclude that "foreign banks have not had a significant effect at [macroeconomic] level: they are more cautious than their local counterparts when extending credit, and their response to crises is clearly pro-cyclical, all of which intensifies the effects of monetary tightening. Despite management efficiency, interest-rate spreads only narrowed in four of the seven countries analyzed, and even in those they remained extremely

one of the main factors responsible for the weak level of financial development –as measures by the ratio of total credit-to-GDP and total financial assets-to-GDP– in their domestic financial systems.

d) The expected results of the foreign bank entry –more diversified portfolio with predominance of credit operations, greater efficiency and enhancement of the soundness of the financial system– did not materialize in Argentina and Brazil. In both countries foreign banks behavior was similar to domestic private banks, in terms of portfolio allocation, credit policy, etc., although in Argentina there are some evidences that in tranquil times foreign bank entry contributed to the enhancement of the financial system. These results in Argentina should be expected as foreign entities in Argentina had a more solid situation than domestic ones, that had been very weakened due to effects of Mexican crisis. Although World Bank and some economists argued that one of the main benefits of the presence of foreign banks in Argentina (and Latin America) was the overall decline in systemic risk, during the Argentina's 2001 crisis foreign banks behavior did not contributed to enhance financial stability of the banking sector. In the case of Brazil, domestic private banks reacted positively to foreign bank penetration, improving their efficiency, obtaining revenue economies through cross-selling activities and at the same time expanding their activities organically or by mergers and acquisitions, as they have some advantages over foreign banks which they can exploit, since they are more adapted to the peculiarities of the Brazilian banking market and accumulated capabilities to survive in an environment of macroeconomic instability. Furthermore, they were less affected by 1994-1995 crisis than domestic banks in Argentina.

e) Changes in banking behavior and improvement in the soundness of the financial system in Argentina and Brazil –in order to reach the desirable macroeconomic efficiency of the financial system– depends crucially on improvements in the macroeconomic environment. Furthermore, as the recent Argentine experience suggests, EMEs must be very careful in adopting a quick and intensive financial liberalization in their economies in order to avoid disruptive process of financial speculation in their financial markets that results in deep real negative effects in the domestic economy.

high –way above rates in Asia, not to mention those in OECD countries–. Spreads have reacted more to the macroeconomic environment than to differences in cost management, and foreign banks seem to be adapting to the national reality in this respect, rather than imposing their own dynamic on the cost of capital".

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