Journal of International Money and Finance 30 (2011) 1180–1194

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

The economic effects of foreign bank presence: Evidence from the Philippines

Maria Chelo V. Manlagñit [a,b,*,1]

[a] Department of Economics, University of Hawai'i at Mānoa, 2424 Maile Way, Saunders Hall Room 542, Honolulu, HI 96822, USA
[b] East-West Center, 1601 East-West Road, Honolulu, HI 96848, USA

Keywords:
Foreign bank entry
Competition effects
Spillover effect
Domestic commercial banks
Philippines

ABSTRACT

This study examines the economic effects of the liberalization of foreign bank entry in the Philippines from 1990 to 2006. The findings provide strong evidence on the dominance of competition effects from foreign bank presence which lead to the reduction in the profitability and overhead costs of domestic commercial banks. These findings, which reveal that both the actual market penetration and mere presence of foreign banks seem to exert competitive pressure to domestic banks, imply that foreign banks may serve as an effective competitive force, reducing the excess profits earned by domestic banks and compelling domestic banks to update their production technologies and techniques to improve their cost efficiency.

From a policy perspective, the findings on competition effects of foreign banks in the domestic banking system justify the liberalization of foreign bank entry in the Philippines. The main findings demonstrate that the goal of banking liberalization in transforming domestic banks to be more competitive and efficient works considerably well in the case of the Philippines. Aside from the policy of easing the entry of foreign banks, bank-specific conditions can have significant impact on the performance of domestic banks. Therefore, a sustained improvement in the efficiency of domestic commercial banks requires not only liberalizing the entry of foreign banks, but also on continued strengthening of domestic prudential regulation and supervision on the commercial banking system.

* Present address: 160 Tan Chong Sablan, 96911 Guam, USA. Tel.: +671 9897692.
E-mail addresses: mcm@hawaii.edu, mcmanlagnit@yahoo.com.

[1] Degree Fellow (2004–2008).

0261-5606/$ – see front matter
doi:10.1016/j.jimonfin.2011.06.015

1. Introduction

According to the United Nations Conference on Trade and Development (UNCTAD), foreign direct investment (FDI) inflows in the world rose from US$55 billion in 1980 to a record high of US$1411 billion in 2000 and settled to US$1979 billion in 2007 before it declined to US$1697 billion in 2008 due to the turmoil in the financial markets and the global financial crisis. Although developed countries hosted a large share of world FDI, the flow of FDI to developing countries has also increased at a faster rate over the years, rising from US$8 billion in 1980 to US$621 billion in 2008. Of the changes in national regulatory from 1992 to 2005, UNCTAD (2006, Table 6) reported that 92 percent are favorable to FDI, reflecting that regulations encourage FDI through simplified procedures, enhanced incentives, reduced taxes and greater openness to foreign investors. This remarkable increase in FDI was largely driven by increases in FDI in service sectors, and in particular in financial FDI. According to the World Bank's 2006 Global Development Finance report, the easing of rules governing cross-border lending and establishment of branches and subsidiaries of foreign banks is among the factors that led to the recent surge in FDI in the banking sector of developing countries. The increasing efforts of developing countries to attract financial FDI are anchored on the potential benefits from relaxing and broadening the entry and scope of operations of foreign financial institutions.

More often, foreign bank entry is associated with spillover effects on domestic banks through their ownership-specific advantages and possession of proprietary technology, on the one hand and through increase in competition, on the other hand. However, the role of foreign bank entry in development has been closely scrutinized following the financial crises in many developing economies in the mid-1990s. As a consequence, the increase in foreign bank presence has prompted rigorous research on its causes and consequences to the domestic banking sector, particularly in developing countries and banking sectors that had long been protected from competition.

In the Philippines, there has been a significant increase in foreign participation in domestic financial system, particularly after the government liberalized the entry and scope of operations of foreign banks in the country in 1994. As a result, the foreign banking share of the total banking assets rose in the second half of the 1990s from about 9.1 percent in 1995 to 14.8 percent in 2000, and finally settling to 10.2 percent in 2009. Despite this increase, previous works in the Philippines on foreign bank presence suggest limited effects on competitiveness, a finding in contrast with the common argument in the theoretical literature on foreign bank entry. Earlier findings seem to suggest that it may still be too early to draw any definite conclusions about the implications of increased foreign bank participation. Nevertheless, an attempt to gain understanding as to whether foreign bank entry alters the performance of domestic banks appears warranted.

The main objective of this study is to examine the economic effects of foreign bank presence in the Philippines using comprehensive data from 1990 to 2006. By focusing on two possible channels through which foreign banks may influence the domestic banking market, this study investigates whether, on average, foreign banks in the country is associated with an increase in the profitability and decrease in overhead costs through spillovers or a reduction in both the profitability and overhead costs through competition effects.

With the entry of foreign banks, there is a need to understand the position of domestic banks in terms of their performance. Understanding the comparative performance of foreign and domestic banks is necessary especially if the existence of foreign banks is assumed to create spillovers or increase the competition in the domestic banking sector. From a policy perspective, this study draws some conclusions on the implications of liberalizing foreign bank entry on the performance of domestic banks in terms of profitability and overhead costs. Therefore, if efficiency spillovers and/or competition effects from foreign bank entry do occur, then host countries like the Philippines aiming to maximize these benefits should focus on measures to attract more foreign banks to enter in the domestic banking market. The findings of this study, therefore, will justify policy aimed at attracting foreign banks, including easing of restrictions on incoming foreign investments and offering (possibly excessive) incentives to foreign banks, as well as the potential costs associated with attracting foreign investors in the financial sector.

The rest of the paper is structured as follows. Section 2 briefly presents the analytical framework on financial sector FDI as well as the competing effects of spillover and competition of foreign bank entry.