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



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ABSTRACT

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

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1. Introduction

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

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

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

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

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

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

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

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

of this hypothesis is not construed as evidence against foreign banks per se; instead, it serves a basis for further exploring complementary policies that encourage foreign banks to meet the financial needs of emerging market exporting firms.

By evaluating the impact of foreign bank participation on export performance within an institutional framework (North, 1986, 1993, 1994), this paper also builds upon an emerging strand of literature that generally finds a positive relationship between institutional quality and export performance (Cuervo-Cazurra and Dau, 2009; LiPuma et al., 2011; Lu et al., 2009). While this paper is most similar to LiPuma et al. (2011), it makes an important departure from the authors' broad coverage of heterogeneous emerging market economies. It does so by focusing on India; and in particular, Indian chemical firms. India is an interesting case because the distribution of firm size is heavily skewed toward very small manufacturing firms in comparison to other emerging economies such as China (World Bank, 2010). Interestingly, too, India's chemical industry is one of its oldest industries, and has the potential to attain a dominant position in the global chemical industry; yet, it has apparently failed to do so because it continues to be dominated by small chemical firms (Export-Import Bank of India, 2007).

By focusing on India, this paper shows that while the improvement in the institutional environment may have a larger marginal impact on the export performance of small emerging market firms relative to their large counterparts (LiPuma et al., 2011), the impact of foreign banks as a stand-alone component of the institutional environment is unlikely to significantly enhance the export performance of these small firms. Importantly, too, this finding adds to the dearth of evidence that casts doubt on the potential for foreign banks to significantly improve the access of small Indian firms to bank credit, all else being equal (Gormley, 2010).

The remainder of this paper is organized as follows. The next section reviews the relevant theoretical and empirical literature to develop the hypothesis to be empirically evaluated. This is followed by a description of the statistical model and data employed. The empirical results are then presented. The final section concludes with a summary of the main finding, and a discussion of the key implication for domestic policymakers.

2. Theoretical and empirical background

The section reviews the theoretical and empirical literature that is relevant for the development of the hypothesis to be empirically evaluated. The hypothesis is directly supported by several lines of research. The first line of research focuses on the relationship between institutional quality and export performance. Building on the institutional framework of North (1986, 1993, 1994), a number of studies provide evidence that appears to generally support a positive relationship between institutional quality and export performance. For instance, Cuervo-Cazurra and Dau (2009) find that structural reforms that make the economy a more market-oriented one may enhance the export performance of firms, and particularly the subsidiaries of foreign firms in the host country.

In another study involving a sample of Chinese firms, Lu et al. (2009) find that the export performance of these firms is positively related to the institutional quality of their business locations. Finally, LiPuma et al. (2011) similarly find that institutional quality (i.e. limited government intervention, fair court system, robust financial markets, and lack of onerous regulations) has a positive effect on the export performance of emerging market firms; furthermore, the magnitude of this positive effect is greater for relatively small and young firms.

To the extent that foreign banks provide an impetus for institutional development in the banking sector of emerging market economies, this first line of research suggests that they may have a positive impact on export performance at the firm level. However, for emerging market economies such as India where very small firms dominate the manufacturing sector relative to China (World Bank, 2010), an important question is whether these small firms will actually gain better access to finance as foreign bank participation increases.

If the entry of foreign banks in the domestic banking sector leads to greater competition, then the potential fall in profit margins across banks may discourage them from investing in soft information production through extensive relationship building activities (Petersen and Rajan, 1995). But if there is a limited amount of soft information available on informationally opaque small firms, then banks

have little, if any, incentive to lend to them. This implies that these small firms may be limited to a small amount of relatively expensive bank credit. Another possibility is that foreign banks may offer credit on favorable terms only to the most profitable and informationally transparent firms that are invariably large in size (Dell'Ariccia and Marquez, 2004; Gormley, 2010; Sengupta, 2007). But this pattern of credit allocation may exacerbate the financial constraint faced by small firms; and therefore, has adverse implications for the expansion of the small-firm dominated private sector in emerging economies (Agénor, 2003).

The final line of research focuses on the relationship between firm size and export performance. The empirical evidence on the relationship between firm size and export performance, measured as the ratio of export sales to total sales (i.e. export intensity), generally supports a systematically positive relationship (e.g. Hirsch and Adar, 1971; Majocchi et al., 2005; Moini, 1995; Wagner, 1995). This positive relationship partly reflects the resource capabilities of large firms relative to their small counterparts (Barney, 1991; Penrose, 1955, 1959). Still, a few studies suggest that a systematic relationship may not exist (Bonaccorsi, 1992; Pla-Barber and Alegre, 2007), and at least one study suggests a negative relationship (Patibandla, 1995). Finally, when domestic and export sales are modeled under a system of simultaneous equations, a positive systematic relationship is found to exist between firm size and export sales (Salomon and Shaver, 2005; Singh, 2009).

In sum, for institutionally deficient emerging market economies, foreign bank participation may be viewed as a potential channel for financial development. If foreign banks operate in this capacity, then their effectiveness may be determined in part by the extent to which they moderate the anticipated positive relationship between firm size and export performance. However, the foregoing discussion of the extant literature suggests that foreign banks are unlikely to offset the resource constraints of small firms through improved access to bank credit in the presence of potentially severe informational problems (Gormley, 2010; Petersen and Rajan, 1995). This leads to the following hypothesis:

Hypothesis. Foreign bank participation will not have a statistically significant moderating effect on the anticipated positive effect of firm size on export sales, all else being equal.

3. Statistical model and data

3.1. Statistical model

In this section I formulate the statistical model that is employed to evaluate the hypothesis established in the previous section. Similar to Salomon and Shaver (2005), I claim that the exporting firm simultaneously determines output for both domestic and foreign markets. The merit of this claim is later evaluated in the next section. Let ES_{it} and DS_{it} denote the export sales and domestic sales of firm i at time t , respectively. I characterize the statistical relationship between domestic and export sales by the following non-recursive system of equations:

$$ES_{it} = \beta_1 DS_{it} + \Gamma_1' x_{it} + \delta_i + \varepsilon_{it} \quad (1)$$

$$DS_{it} = \beta_2 ES_{it} + \Gamma_2' w_{it} + \delta_i + \eta_{it} \quad (2)$$

where x_{it} and w_{it} are vectors of explanatory variables; δ_i is a firm-specific time-invariant term that accounts for unobserved heterogeneity; ε_{it} and η_{it} are error terms with constant variance and zero mean. I apply the standard assumptions that ε_{it} is uncorrelated over time and across firms, and uncorrelated with the vector X_{it} ; similarly, η_{it} is uncorrelated over time and across firms, and uncorrelated with the vector W_{it} . However, ε_{it} and η_{it} are assumed to correlate for any given firm and time; that is, unanticipated changes in domestic sales and export sales are correlated.

The time-invariant unobserved heterogeneity component, as captured by δ_i , is typically problematic for cross-sectional data. However, the use of panel data addresses this problem in a straightforward way. By averaging Eqs. (1) and (2) over time for each i , I obtain *between transformations* of the equations which are then subtracted from (1) and (2) to eliminate δ_i . Under the assumptions stated above, the two stage least squares (2SLS) fixed-effects estimator is a consistent estimator of the parameters β_1 , Γ_1' , β_2 and Γ_2' . This consistency property of the 2SLS (fixed-effects) estimator directly follows from the fact that it constitutes a special case of the Instrumental Variable (IV) estimator that is already

known to be consistent (Kennedy, 2008). To formally offer a justification for the use of the 2SLS fixed-effects estimator rather than the 2SLS random effects estimator, I apply the Hausman test in the next section.

Importantly, this system of equations is identified if the vector $X_{it} - \bar{X}_i$ contains elements that are excluded from the vector $W_{it} - \bar{W}_i$; and similarly, $W_{it} - \bar{W}_i$ contains elements that are excluded from $X_{it} - \bar{X}_i$ (Green, 2000). That is, the system of equations is identified for a set of explanatory variables that predict export sales only, and another set of explanatory variables that predict domestic sales only. The equations are identified under the following specification of the non-recursive system of equations:

$$ES - \bar{ES} = f(\widetilde{DS}, \widetilde{R\&D}, \widetilde{REER}, \widetilde{DS \cdot FBP}) \quad (3)$$

$$DS - \bar{DS} = f(\widetilde{ES}, \widetilde{R\&D}, \widetilde{Domestic\ GDP}) \quad (4)$$

where *REER* denotes the real effective exchange rate (index); *FBP* denotes foreign bank participation; *R&D* denotes research and development expenditure; and *Domestic GDP* denotes the domestic gross domestic product. All right-hand side variables are measured as deviations from their average values. Following Singh (2009), *domestic sales* is used as a measure of firm size. While the number of employees was also considered as a measure of firm size, the unavailability of such data precluded its use.

The interaction of *domestic sales* and *foreign bank penetration*, *DS · FBP*, and the REER are used to predict export sales only. The REER essentially approximates the intrinsic value of a country's currency relative to the currencies of its trading partners. It is generally computed as a weighted average of the bilateral real exchange rates between the country in question and its trading partners, where the weights are given by the trade shares of each partner (Catão, 2007). A rise (fall) in the REER indicates an appreciation (depreciation) of the domestic currency in real terms. The depreciation of the domestic currency in real terms is generally considered to constitute a favorable exchange rate shift for exporters engaged in bilateral trade; that is, such a shift enhances the international competitiveness of exporters, which in turn increases export sales (Bernard and Jensen, 2004; Campa, 2004). Therefore, other things being equal, a negative relationship is expected between REER and export sales.

Similar to Salomon and Shaver (2005), I use *domestic GDP* as a determinant of domestic sales only. However, I depart from the authors by not using advertising expenditure as a determinant of domestic sales. I chose not to include advertising expenditure in the model because it is almost uniformly negligible across the sample of Indian chemical firms used in this study. This is so because Indian chemical firms generally produce generic rather than branded products that typically require significant levels of advertising expenditure.

The R&D expenditure variable is included in both equations, and is expected to have a positive impact on export sales (Buckley and Casson, 1976; Cooper and Kleinschmidt, 1985; López-Rodríguez and García-Rodríguez, 2005; Moini, 1995; Singh, 2009; Wagner, 1995). Finally, although Majocchi et al. (2005) include firm age as a determinant of export performance, this variable was not included in the regression model because data on firm age was not available for the sample of Indian firms used in this study.

3.2. Data

The data used to test the hypothesis developed in Section 2 constitutes an unbalanced panel of 930 firm-year observations on Indian chemical firms over the period 1997–2005. A number of data sources were used to develop this panel dataset. I obtained data on total sales, export sales and R&D expenses for 130 Indian chemical firms between 1997 and 2005 from the Prowess database. This database contains the audited annual filings of over 10,000 Indian firms, and is published by the Center for Monitoring Indian Economy (CMIE), an independent economic think-tank headquartered in Mumbai, India. From the data on total sales and export sales, domestic sales were calculated as a straightforward exercise.

I also obtained annual GDP (measured in constant prices) data from the official website of the Bank of India (RBI). In addition, I collected monthly data series on India's real effective exchange rates between 1997 and 2005 from the Bank for International Settlements (BIS). The annual real effective

exchange rates were then computed as simple averages of the monthly series for the respective years. Lastly, I obtained data on foreign bank participation in India from the dataset compiled by Claessens et al. (2008).

4. Results

Table 1 provides the mean, standard deviation and correlation coefficients for the variables used in the regression model. Importantly, the data does not appear to exhibit a multicollinearity problem with the highest two pairwise correlation coefficients being 0.603 and 0.520 for the pairs of variables {domestic GDP, REER} and {export sales, R&D expenditure}, respectively. Consistent with the claim that domestic sales and export sales are interdependent, I observe a statistically significant correlation measure of 0.438 for the pair of variables {export sales, domestic sales}. This preliminary result will be revisited later on in this section. Altogether, the substantial variation in the firm-level data, and the apparent absence of a multicollinearity problem make the application of the 2SLS fixed-effects estimator a relatively straightforward exercise.

Columns 1 and 2 of Table 2 provide the 2SLS fixed-effects estimates for Eq. (3) (with export sales as the dependent variable) and Eq. (4) (with domestic sales as the dependent variable), respectively. According to the hypothesis developed in Section 2, the moderating effect of foreign bank participation on the anticipated positive relationship between firm size and export sales is expected to be statistically insignificant. The magnitude of this moderating effect is captured by the coefficient on the variable $FBP^*Domestic\ sales$. As shown in column 1 of Table 2, the anticipated positive relationship between firm size (as measured by domestic sales) and export sales is confirmed based on the statistically significant coefficient on domestic sales ($\beta = 0.271$, $p < 0.001$); and importantly, the hypothesis appears to be supported by the data based on a negative coefficient on the variable $FBP^*Domestic\ sales$

Table 1
Descriptive statistics and correlation coefficients.

Variables	Mean	S.D.	1.	2.	3.	4.	5.	6.
1. Export Sales	50.22	143.19	–					
2. Domestic Sales	362.97	731.79	0.438*	–				
3. R&D expenditure	4.05	15.78	0.520*	0.150*	–			
4. Domestic GDP	2,076,040	293,878	0.174*	0.074*	0.134*	–		
5. REER	95.83	2.27	0.102*	0.037	0.090	0.603*	–	
6. FBP (%)	4.45	1.32	0.036	0.036	0.025	0.198*	–0.256*	–

REER, real effective exchange rate index.

FBP, foreign bank participation.

1, 2, 3, 4 are in 10 million Indian national Rupees (INR).

N=930.

* Statistically different from zero at the 1 percent significance level.

Table 2
2SLS fixed-effects estimates.

	Export sales:		Domestic sales:	
	Coefficients	Std. error	Coefficients	Std. error
Domestic sales	0.271***	0.053		
Export sales			0.052	4.230
R&D expenditure	2.754***	0.301	2.113	14.264
Domestic GDP			0.000	0.000
REER	–0.423	1.589		
FBP* domestic sales	–0.000	0.002		
N	930		930	
Adjusted R ²	0.27		0.13	

* Significant at 10 percent.

** Significant at 5 percent.

*** Significant at 1 percent.

that is not statistically different from zero. That is, while foreign bank participation may attenuate the positive relationship between firm size and export performance, the magnitude of this moderating effect is insignificant in both statistical and economic terms.

In addition, a systematic positive relationship appears to exist between R&D expenditure and export sales ($\beta = 2.574$, $p < 0.001$). However, the R&D expenditure variable is not statistically significant for domestic sales as shown in column 2 of Table 2. Finally, the finding of a negative coefficient on the REER variable in column 1 of Table 2 is generally consistent with theory; however, this variable is not statistically significant for the sample of Indian chemical firms used in this study.

It was noted earlier that the statistically positive correlation between domestic sales and export sales in Table 1 constituted preliminary evidence in support of the claim that export sales and domestic sales are interdependent. This issue is revisited here. From the results in Table 2, it can be seen that the domestic sales variable has a statistically positive effect on export sales. However, while the export sales variable has a positive effect on domestic sales, this marginal effect is not statistically different from zero. Still, these findings are generally consistent with the claim that export sales and domestic sales may be determined interdependently.

Another important check concerns the use of the 2SLS fixed-effects estimator rather than the 2SLS random-effects estimator for the model specification. I employ the Hausman test to determine whether the assumption that the unobserved heterogeneity is uncorrelated with the regressors holds for the data. For the Hausman test employed, the 2SLS random-effects estimator is consistent only when this assumption holds; however, the 2SLS fixed-effects estimator remains consistent even when this assumption is violated. The Hausman test does not appear to provide support for the assumption that the unobserved heterogeneity is uncorrelated with the regressors; hence, the use of the 2SLS fixed-effects estimator seems to be appropriate for the data.

Finally, since the 2SLS fixed-effects estimator is based on the crucial assumption of homoskedastic disturbances, I relaxed this assumption and used the generalized method of moments (GMM) estimator to obtain the coefficient estimates for the regression model characterized by Eqs. (3) and (4). However, the key qualitative results remain the same, and the support for the hypothesis is maintained.

5. Conclusion

This paper empirically evaluates the magnitude of the potential mediating effect of foreign bank participation on the anticipated positive firm size–export sales relationship using panel data on Indian chemical firms. The empirical evidence suggests that higher foreign bank participation in the domestic banking sector may attenuate the positive firm size–export sales relationship; however, this mediating effect is not significant in both statistical and economic terms. This finding has an important implication for policymakers in emerging market economies such as India, among others.

To the extent that domestic policymakers are looking to relax the financial constraint on the international expansion of indigenous firms almost exclusively through policies that welcome foreign banks, this study casts doubt on the effectiveness of such policies; that is, the evidence suggests that foreign banks are unlikely to enhance the capacity of emerging market firms to serve foreign markets through better access to bank credit, all else being equal. Yet, in so far as emerging market exporters are underserved by foreign banks because of their informational opacity, emerging market governments that welcome foreign banks may generally encourage them to serve indigenous firms by implementing complementary policies that either improve the latter's transparency, or circumvent their inherently risky credit profile.

As a practical matter, however, it may be worthwhile for domestic policymakers to place greater priority on workable initiatives that may generally help indigenous firms to access bank credit despite their risky credit profile. Among the potential policy solutions along this line, a “reverse factoring” scheme is worth considering (Klapper, 2006). Unlike alternative schemes that tend to call upon fiscally constrained emerging market governments to offer explicit or implicit loan guarantees, reverse factoring is predicated on self-help. That is, the primary goal is to help emerging market firms to obtain working capital on the basis of unpaid invoices generated from credit sales made to relatively large, creditworthy clients at home and abroad.

In principle, if an emerging market exporter had sold goods on credit to well-established international corporations, reverse factoring would enable this exporter to sell the unpaid invoices to a third party (i.e. a factor) in exchange for a sum of money that is normally less than the face value of the invoice (i.e. discounted value). If emerging market governments allow foreign banks to provide factoring services along this line, such transactions are expected to take place because they are predicated on the creditworthiness of international firms that just happen to be the clients of emerging market exporting firms.

Thus, for emerging market economies characterized by weak credit market information infrastructure, financial policies that encourage foreign banks to provide reverse factoring services may circumvent one of the most formidable institutional barriers that seem to partially block credit flows to indigenous exporting firms. At the same time, if emerging market governments are able to successfully implement a broader set of policies that substantially improve the credit information infrastructure, and the legal and regulatory framework needed to support factoring on a larger scale, then small emerging market exporters may be better placed to secure working capital financing from foreign banks by using a larger share of what may very well be substantial amounts in uncollected accounts receivable.

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