

**Ownership and Opportunity:  
Why Bankers in Emerging Markets Support Financial Internationalization\***

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# **Openness without Liberalization: Why Bankers in Developing Countries Support Financial Internationalization**

## *Abstract*

Financial sectors in the developing world pressure governments to open capital accounts, a policy which standard theories of open economy politics predicts would harm their interests. I explain this contradiction by studying international financial intermediation, showing that lenders prefer open capital accounts to lower the cost of capital, but also prefer ownership restrictions to avoid competing with foreign banks. I test the predictions of this theory on two datasets on foreign entry restrictions in the developing world, and by examining interest group pressures for financial internationalization in Indonesia, Mexico, and Senegal. The findings add much-needed theoretical rigor to the study of financial internationalization in the developing world.

## **1. Introduction**

In exploring the politics of finance, scholars have focused on a range of variables believed to promote financial internationalization, from ideas to interests to international linkages. A large qualitative literature finds that domestic financial interests have played a significant role in lobbying for capital account openness. In developing countries and emerging markets from Argentina to Turkey and from Egypt to the Philippines, analysts have found that owners of financial capital resist capital controls, both in the form of laws that prevent them from moving funds overseas and in the form of restrictions on the inflow of foreign capital.

This observation challenges conventional theories of open economy politics. Financial sectors in emerging markets, since they are relatively capital poor by global standards, should be swamped by foreign capital under conditions of full openness. In fact, there is abundant microeconomic evidence that foreign banks in developing economies outcompete their domestic counterparts, offering lower interest rates, mobilizing more funds from large depositors, and

earning greater profits than domestic banks (see e.g. Claessens et al. 2001; Clarke et al. 2001; Laeven 2002; Micco et al. 2007; Claessens and Lee 2003; Demirgüç-Kunt et al. 2004).

Yet still, in many parts of the developing world domestic lenders lobby for cross-border financial openness, the very policy that standard theories predict would harm their interests. Qualitative evidence on this regard is difficult to ignore. Scholarship on Indonesia, for example, has long identified the interests of financiers who for decades pressured the regime to maintain an open capital account—one open both to outflows *and inflows* (MacIntyre 1993; Winters 1996). Research on Mexico from the 1970s through the 1990s has confirmed that Mexican bankers have long favored an open capital account, strongly resisted the decision of President López Portillo to restrict capital flows between 1982 and 1987, and supported later decisions to return to capital openness in order to promote capital inflows (Maxfield 1990; Lustig 1998; Loriaux et al. 1997). Looking cross-nationally at these countries and others, Haggard and Maxfield (1996) note that the financial sector in emerging economies should resist foreign competition, but then argue that lenders and financiers respond to balance-of-payments crises by lobbying for financial liberalization. Quantitative evidence also confirms this relationship. For example, Brooks (2004) finds in a sample of Latin American countries—all emerging markets or lesser developed countries—that large financial sectors lead to more capital account liberalization.

How can we reconcile the political actions of bankers and financiers in developing economies with theories of open economy politics? I argue in this paper that a special aspect of financial capital gives financial institutions an incentive to favor capital openness alongside foreign ownership restrictions. That aspect of financial capital is its fungibility. Capital borrowed from a creditor, investor, or depositor can be lent immediately to other actors, from

firms to individual borrowers. Lenders make profits through such intermediation between economic actors. A developing country lender will oppose competition from foreign financial institutions, and resist foreign acquisitions of domestic lending institutions, but will welcome inflows of foreign funds which it can then intermediate into the domestic market—thereby profiting directly from cheap foreign funds without subjecting itself to competition. Lenders in developing countries should therefore push for capital account openness, which gives them access to foreign capital, with ownership restrictions, which ensures that they must intermediate between foreign banks and domestic borrowers. They should pressure governments for capital market openness without financial liberalization.

I marshal several different types of empirical evidence, both qualitative and quantitative, to support my argument. In a broad sample of developing countries, I show that banking sector size is positively associated with limitations on foreign entry into the banking sector. Using time-series data from nineteen emerging market economies, I also show that financial sector size is positively associated with ownership restrictions in equity markets. Using qualitative evidence, and because sectoral size may not proxy for political influence, I study financial internationalization in Mexico and Indonesia, two hard cases for existing theories due to their long-term capital account openness. Consistent with my expectations, I find that high levels of openness to capital flows were accompanied by substantial restrictions on foreign financial ownership, and that such policies conformed to the preferences of the banking sector. In Senegal, I find that absent a strong banking sector, governments have opened Senegal to foreign financial ownership to meet Senegalese corporates' financing needs. Together, qualitative and quantitative findings establish that there is a coherent logic of financial sector pressure for capital account openness in the developing world, one consistent with both stylized facts about financial

sector actors' preferences for capital mobility uncovered in the qualitative literature *and* theories of sectoral politics in an open economy.

The contributions of this paper are three-fold. First, by taking distributional preferences seriously, I add theoretical rigor to the study of financial internationalization in the developing world. Most correlational studies have ignored the interest group dynamics of financial internationalization in favor of economic and institutional variables (Leblang 1997), or alternatively, have focused on “ideas” (Quinn and Toyoda 2007) or on the OECD (Quinn and Inclán 1997). Other empirical studies (i.e. Chwioroth 2007; Brooks 2004) follow the qualitative literature and hypothesize that financial sectors should pressure developing country governments to open their capital accounts, not acknowledging that without substantial refinement, this prediction contradicts standard theories. Second, I present rigorous cross-national tests of the political economy of financial ownership in the developing world. Country specialists have long noted the resistance of powerful financial sector actors to foreign entry in countries with very open capital accounts. I illuminate the logic behind these findings, and then test their observable implications around the world.

Finally, by interrogating the very broad concept of “financial internationalization,” I draw attention to the difference between movement and entry in the international economy. Existing research has conflated either the two concepts without recognizing the critical distinction between them (Lukauskas and Minushkin 2000), or studied capital account liberalization without recognizing the preferences of the domestic financial sector (Haggard and Maxfield 1996). Distinguishing between movement and entry and focusing on the fungibility of capital recovers the prediction of why lenders favor capital account openness—to access cheap foreign capital—and financial ownership restrictions—to avoid competing with it. It also allows me to extend

this analysis of preferences over financial liberalization to other areas of globalization. In the conclusion I argue that distinguishing between movement and entry suggests intrasectoral cleavages in preferences over trade liberalization, with producers in import-competing sectors resisting trade openness but distributors in import-competing sectors preferring openness without trade liberalization.

## **2. Trade in Capital**

Treating financial capital as an ordinary good allows for a straightforward interpretation of the distributional consequences of its movement across borders. Standard trade theory shows that cross-border factor movements have distributional consequences for actors based on their countries' relative factor endowments. Specifically, in the Stolper-Samuelson extension of the Heckscher-Ohlin model of international trade, free trade movement in a factor (such as labor, capital, or a specific good) across borders harms actors in a country where that factor is scarce, and benefits actors in a country where that factor is abundant (Stolper and Samuelson 1941). For example, a country where land is relatively abundant compared to labor has a global comparative advantage in the export of goods produced through farming, and a comparative disadvantage at exporting labor-intensive goods. Free trade raises global demand for export of farm goods, to the benefit of farmers, but lowers the demand for export of labor-intensive goods (which are presumably produced more cheaply elsewhere), to the benefit of labor.

The Heckscher-Ohlin model of international trade assumes that all factors are mobile across sectors. In the alternative Ricardo-Viner model of international trade, predictions differ slightly based on the assumption that at least some factors are immobile across sectors (Jones 1971; Mussa 1974). Now, the distributional effects of free trade are less straightforward. As is standard, assume an economy with two sector-specific capital industries: wheat milling and

microchip assembly. The former is competitive on the export market, but not the latter. Assume also that there is a pool of labor that is perfectly mobile between the two sectors. Free trade benefits the export competitive specific factor (wheat milling) and harms the uncompetitive specific factor (microchip assembly) not only through international competition, but also because the uncompetitive specific factor must raise wages to retain its labor force. Free trade's impact on the real wages of labor is ambiguous: workers who consume mainly export goods will suffer, but those who consume mainly import goods will benefit.

It is straightforward to apply this logic to the movement of financial capital across borders. I focus here on the developing world, where capital is scarce as compared to labor and rates of return for investment are higher than the developed world. Following the Heckscher-Ohlin model, in capital-poor countries, free trade in capital should encourage capital to flow to the developing world. This should harm capitalists, who are at a comparative disadvantage with capitalists in capital-rich countries of the developed world. Perhaps more realistically, the Ricardo-Viner model predicts that in these economies, financial capital (the non-competitive specific factor) should suffer from free trade in capital while industrial capital (the export competitive specific factor) should benefit from free trade in capital. Industrial capital has access to cheaper foreign credit from abroad, which forces local financial capital to compete on the terms of more "productive" foreign financial capital. In either model, the loser from trade in capital is the financial sector in the developing world (Frieden 1991).

Both models are helpful not only in understanding the distributional implications of free trade, but also the political coalitions that align around protectionism. They predict that pressure for protectionism will come from the actors in an economy that suffer from free trade. Abundant evidence confirms these hypotheses, both in the realms of both trade (movement of goods) in

addition to the realm of immigration (movement of labor). But no such evidence exists for the movement of financial capital. Indeed, the research cited above confirms that cross-nationally, developing countries with strong financial sectors pressure governments to open their borders to cross-national capital flows. Meanwhile, other research cited previously confirms that the predictions of both the Heckscher-Ohlin and Ricardo-Viner models are borne out in developing countries: given the opportunity, foreign banks outcompete domestic banks.

The fact that the microeconomic evidence supports standard models suggests that they should be useful for understanding the distributional implications of cross-border capital flows. The qualitative evidence on the political influence of financial capital in the developing world, though, suggests that we should not discard the assumption that bankers successfully pressure governments to protect its interests. The challenge is to understand how these interests map onto capital account openness.

### *2.1. Fungible Capital and Financial Intermediation*

We can understand how financial capital can support capital account openness by distinguishing among different financial sector actors, and by studying more closely what financial institutions actually do in the developing world. To accomplish the first task, among financial sector actors we can identify three groups: corporate borrowers, direct lenders and brokers, and institutional investors. Corporate borrowers seek access to capital to fund their enterprises, and are akin to “industrial capital” in the Ricardo-Viner model. Institutional investors remain a relatively small segment of the financial market in most developing countries. Unless otherwise noted, in the remainder of the paper I focus on the preferences of direct lenders and brokers.

Direct lenders and brokers have a singular commonality: they operate as businesses by borrowing from some agents and lending to others. This practice of financial intermediation is present in all modern economies.<sup>1</sup> “Borrowing” in this sense has many related attributes: it may mean literal borrowing, or it may mean broader liabilities such as accepting individual deposits. “Lending” can be to both banks and firms, both through loans and through equity investments. Whatever the structure of the transactions between external agents and the financial institution, the commonality is that direct lenders are both creditors and debtors, and they make profits through this enterprise. The existence of both lending and borrowing activities is critical, for it is through amassing capital through borrowing that lenders are able to lend, and it is through returns above the cost of their debts that they are able to make profits. And it is the fungibility of capital that allows a dollar borrowed to become a dollar lent. Aside from profits, no portion of capital is used up or otherwise destroyed through trade. Moreover, unlike trade in goods, capital has no directly productive use that gives it intrinsic value for consumption.

Theories of financial intermediation show that the transactions costs associated with direct agreements between buyers and sellers make financial intermediation necessary (Rubinstein and Wolinsky 1987; Benston and Smith 1976; Diamond 1984). In most models, these transactions costs are natural: a time-consuming matching process, discontinuities between credit and liability streams, costly monitoring of borrowers by creditors, and inefficient decentralized markets for liquidity. But intermediaries may purposively create transactions costs through legal regulation or other means. Single-purchaser-single-seller laws are a common method where a firm lobbies a government to allow it to act as the sole purchaser of a commodity (allowing it to extract monopsony rents) as well as the sole distributor of that commodity (allowing it to extract monopoly rents). In this way, legal restrictions can create

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<sup>1</sup> For a recent overview of financial intermediation, see Gorton and Winton (2003).

intermediaries. It is straightforward to extend this to financial intermediation. Direct lenders may lobby for regulations that ensure that it is the sole borrower and creditor for financial transactions. It is common in the developing world for a small group of lenders to dominate a country's financial sector—oligopsonists as borrowers, and oligopolists as creditors—to their great profit.

The key insight is that in the developing world, lenders do not just intermediate between actors within their own borders, they also intermediate between foreign creditors and domestic borrowers. When economies ban international capital inflows, the supply of credit depends solely on its availability within that country. Where capital is scarce, as in the developing world, limits on capital inflows raise the cost of capital, making loans more expensive for industrial or small-scale borrowers. Capital account openness lowers the cost of borrowing in the developing world by making available relatively inexpensive foreign capital (Obstfeld 1998; Henry 2000). Critically, capital account openness to foreign capital inflows lowers the cost of borrowing for all actors, *including domestic financial intermediaries*. But while cross-border capital flows decrease the cost of capital for developing country direct lenders in their capacity as borrowers, it threatens developing country direct lenders in their capacity as lenders. If foreign capital can flow directly to firms or equity markets from foreign lenders, its lower cost will allow them to outcompete domestic lenders.

Developing country lenders accordingly seek policies that allow them to benefit from the lower costs of capital that capital openness provides, but shield them from competition. These policies will welcome capital inflows but restrict how they flow into an economy. Specific policies include ceilings on foreign ownership in equity markets, restrictions on the commercial entry of foreign direct lenders, limitations on the ability of foreign financial firms to mobilize

domestic deposits, and restrictions on the ability of foreign lenders to lend to domestic firms. Such regulations on commercial presence, domestic lending, and equity ownership all operate to the benefit of domestic lenders by shielding them from foreign competition. But as intermediaries with an open capital account, these same domestic lenders can still access cheap foreign funds, and then allocate them domestically as they choose. Because capital is fungible, a Mexican bank can borrow dollars abroad to lend as pesos domestically. The bank profits from abundant foreign capital, without fearing competition from foreign banks due to size and market share restrictions for foreign lenders.

The solution to the puzzle of why financial sector actors prefer capital account openness, then, is that under the broad heading of “financial internationalization,” capital account openness is conceptually distinct from cross-border financial liberalization. In simple terms, movement is different than entry. Indeed, developing country lenders have incentives to favor having the ability to access foreign credit in order to intermediate it to the domestic market. Capital account liberalization is not akin to trade liberalization in the presence of foreign ownership restrictions. Direct lenders in the developing world can lobby for and enjoy protectionism through ownership restrictions—consistent with models of sectoral pressures in an open economy—rather than through limitations on cross-border capital trade. But the fungibility of financial capital means that by acting as intermediaries, they actually profit from capital inflows, which lower their cost of capital as borrowers. This phenomenon is largely unique to trade in capital, and explains pressures for capital account openness without financial liberalization.

## *2.2. Ownership Restrictions: Alternative Views*

My argument holds that bankers should lobby governments to restrict foreign entry into their financial sectors at the same time that they welcome capital inflows. I expect that countries

with larger and more politically powerful domestic banking sectors will enact more restrictions on foreign ownership of financial assets. The argument is simple, and consistent with standard political theories of open economy lobbying and economic theories of financial intermediation. But why else might a country restrict foreign entry into its financial sector?

The primary alternative explanation for high levels of financial repression is a state-centric logic of infant industry protectionism. Simply put, financial sectors in the developing world are too small to compete with foreign financial institutions, so they require protection as they grow into national champions that can compete in the global financial marketplace. This logic exactly parallels that of import-substitution industrialization, where governments identify sectors which are globally unprofitable, and shield them from international competition in order to jumpstart industrialization (Prebisch 1959). Note, though, that this hypothesis makes an opposite prediction about the link between banking sector size and protectionism. Under the infant industry argument, it is the smallest and weakest sectors that receive protection, not the strongest ones as hypothesized above. The empirical section below therefore tests the two hypotheses against one another in examining the link between banking sector size and foreign ownership restrictions.

A second alternative explanation is institutional. Numerous country studies have noted how authoritarian regimes resist financial liberalization because of political utility of a repressed financial sector. Absent competitive pressures from foreign banks, authoritarian regimes can use their countries' controlled financial sectors to allocate credit to connected firms. The impetus for retaining ownership restrictions here is neither sectoral pressures nor national interests, but rather the political exigencies of authoritarian rulers. Authoritarian regimes, moreover, likely respond to the interests of a narrower fraction of their citizens than democratic regimes (Buena de

Mesquita et al. 2003), and hence will be more beholden to special interest pressures than a regime whose constituents include laborers and farmers along with industrial and manufacturing enterprises eager to access cheap foreign credit. Such arguments imply that more democratic regimes should be more likely to liberalize their financial sectors. A different view, though, holds that in the developing world as in advanced industrial democracies, such use of the financial sector is valuable to democratic regimes in the same way as it is to authoritarian regimes. Austria, for example, only deregulated its financial sector in order to accede to the European Union, and even today Austrian banks retain tight links to the country's political parties (Braumann 2002). The Philippines is a prime example of a developing country with a democratic government but still notoriously high levels of political interference in the financial sector (Hutchcroft 1998). Such experiences suggest that the link between political regimes and financial liberalization is at best tentative.

### **3. Cross-National Evidence**

I turn now to cross-national empirical tests. Because this paper focuses on ownership liberalization, and because existing evidence is compelling, I do not retest the evidence marshaled by qualitative scholars that financial sector actors lobby for capital account openness, or cross-national research links financial sector size to capital account openness (Johnston and Tamirisa 1998; Brooks 2004). Rather, I treat this as an established hypothesis.

The major difficulty in assessing the link between interest group pressure from lenders and ownership restrictions is measurement, for interest group pressures are seldom directly recorded. This task is more difficult in the developing world and in non-democratic settings. In proxying for the political importance or influence of the financial sector, then, I follow existing

work by measuring sectoral size and assuming a direct link between size and political influence.<sup>2</sup> I use a standard dataset of financial sector indicators compiled by Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine (2000). Consistent with earlier work, I measure the size of the financial sector as the ratio of domestic money deposits to the sum of domestic money deposits and central bank assets (*SIZE*). I supplement this with the ratio of central bank assets to gross domestic product (*CBAGDP*), which controls for the possibility of a country that simply has few central bank assets. In some models, I also include a variable measuring banking sector industrial concentration as an additional measure of the political influence of the financial sector. The variable, *CONCENTRATION*, measures the ratio of the assets of the country's three largest banks to total banking assets. I include it in several models as an additional control variable, and also explore whether or not the effect of the two variables is interactive—whether countries with large *and concentrated* financial sectors create more pressure against foreign ownership liberalization. In the subsequent section, I use qualitative evidence to interrogate the link between these measures of size and the variable of interest, political influence, more closely.

The second difficulty lies in measuring ownership restrictions. There exist no cross-national data on financial ownership restrictions with complete coverage of even half of the world's developing countries. Even among data that do exist, sometimes heroic assumptions of equivalence are necessary—the relationship between 49% limits in equity investment and 49% limits in foreign bank ownership is far from clear. Nevertheless, two different measures of foreign ownership restrictions are available for at least some developing countries. The first is a cross-sectional measure of limitations on foreign bank entry compiled by James Barth, Gerard

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<sup>2</sup> This practice is also standard in the subnational and cross-national literatures on tariff policy preferences. For other uses of national sector size as a proxy for sectoral political influence in the realm of international finance, see Blomberg et al. (2005), Brooks (2004), Chwioroth (2007), Frieden et al. (2001), Quinn and Inclán (1997), and Shambaugh (2004).

Caprio, and Ross Levine (2004). The second is a measure of foreign ownership limitations in nineteen developing country equity markets between 1989 and 2000, compiled by Hali Edison and Francis Warnock (2003). The two measures differ in the empirical referents of ownership restrictions that they measure: the former concentrates on legal restrictions in the banking sector, while the latter focuses on the profit-making activities of foreign financiers. I describe the data for each in the following sections, and then discuss control variables, estimation techniques, and results.

### *3.1. Measuring Ownership Restrictions*

The Barth et al. measure of limitations on foreign bank entry and ownership (hereafter: LFBE) offers a clean measure of foreign entry restrictions in the banking sector. Compiled from a large World Bank survey of supervisory and regulatory officials from around the world, their variable *LIMIT* is coded 1 in countries with any limitations on foreign ownership of domestic banks or entry of foreign banks into the domestic market, and 0 otherwise.

Although the variable *LIMIT* directly measures the key dependent variable of interest, there are some weaknesses with the measure. Data are only measured once, making it impossible to gauge how growing banking sector strength within countries affects their banking sector liberalization choices. So estimates of the effect of banking sector size on commitments to liberalization are static, and identified solely on cross-country variation. Additionally, the binary nature of the measure obscures more subtle variations between countries. Nevertheless, the data offer a clean and simple way to test the argument that large financial sectors inhibit banking sector entry in the developing world.

The Edison and Warnock measure of foreign equity ownership restrictions (hereafter: FEOR) provides a continuous measure of the extent of financial liberalization in emerging

market economies by focusing on the ability of foreigners to invest in a country's equity markets. Using monthly data from the International Finance Corporation, it calculates the percent of each country's equity market which is closed to foreign participation as one minus the ratio of market capitalization open to foreign participation to total market capitalization, each corrected by price indices to smooth out asymmetric price shocks. To measure liberalization, I create yearly averages of their measure and subtract 1 from that average to create a yearly variable called *LIBERAL*. Increasing values correspond to increasing levels of foreign equity ownership liberalization.

The FEOR dataset offers several benefits when compared to the LFBE data. It is available and easily reproducible on a yearly basis between 1989 and 2000, and it offers reasonable coverage of a number of emerging market economies across the world with varying levels of capital account openness. This provides a method to gauge change over time within countries. Additionally, the variable *LIBERAL* allows for fine distinctions between degrees of financial liberalization across country and across time, meaning that openness is not a dummy variable that either is or is not present.<sup>3</sup> The measure, moreover, is distinct from capital controls, concentrating tightly on equity market investment restrictions. It focuses exclusively on inward-directed equity restrictions, obviating the concern in many studies of capital account liberalization that measures do not distinguish between inward and outward controls. It measures directly the policy components of financial liberalization in emerging market economies rather than indirect policy inputs (official claims) or their economic consequences (actual flows). Finally and most importantly, it allows us to move from legal restrictions on bank entry to their behavioral consequences, focusing on the very profit-making activity that my

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<sup>3</sup> The vast majority of the literature surveyed by Henry (2006), for instance, conceives of liberalization as a dummy variable which begins with either a "large" increase in the IFC's investability index or with the first listing of a closed-end developing country fund.

theory suggests should be restricted. The measure does suffer from several weaknesses, however. It does not measure the extent to which banks rather than governments or individual investors are the beneficiaries of foreign equity ownership restrictions. It only indirectly measures foreign ownership of financial assets in general, as it focuses on equity markets and publicly traded companies. Viewed differently, though, this last weakness is a strength: the narrow measure of restrictions on equity ownership is precisely the area in which foreign financial firms can achieve their greatest profits.

### *3.2. Control Variables*

The paucity of research on the cross-national determinants of financial ownership restrictions means that existing research provides few clues as to potential alternative explanations for ownership restrictions, aside from interest group pressures from financial sector actors. This is in marked contrast to capital account openness, for which analysts have proposed a rich set of potential economic and political covariates—factors such as exchange rate regimes, international reserves, and current account balances that have clear theoretical links to capital movements but not to domestic ownership regulations. Given the incomplete state of knowledge about the determinants of ownership liberalization, I focus on five key variables to capture potential alternative explanations of financial sector liberalization.

The first two variables are economic: a country's level of development as measured by per capital real gross domestic product (*GDPPC*), and yearly economic growth (*GROWTH*) (Heston et al. 2006). All countries under consideration are developing countries or emerging market economies, so all are relatively capital-poor. But wealthier countries may find it easier to resist pressures for financial protectionism due to more diversified economic bases.

Alternatively, they may be less capital-poor than other countries and accordingly have less of a

need to protect their financial sectors from international competition. For this reason, more developed countries should be more likely to liberalize their financial sectors to foreign participation. A similar logic holds for economic growth. Findings that financial crises spur financial opening (Haggard and Maxfield 1996), however, suggest that countries experiencing economic booms will face *less* pressure to liberalize their financial sectors. Given these opposing hypotheses, the expected impact of economic growth on financial liberalization is ambiguous.

A third control variable measures regime type using the Polity IV dataset (*POLITY2*) (Polity IV Project 2006). As argued above, many qualitative studies suggest that authoritarian regimes profit from controlled financial sectors. These arguments imply that the effect of democracy on ownership liberalization should be positive. Other country experiences, though, question whether the political utility of a controlled financial sector is unique to authoritarians. If not, then there should be no relationship between level of democracy and financial sector liberalization.

The fourth control variable is capital account openness (*KAOPEN*), as measured by Chinn and Ito (2006). I argue that lenders will pressure governments both to open capital accounts and to retain tight ownership restrictions. But the opposite is not true: in countries where financial sectors are relatively weak, governments may both retain closed capital accounts and restrict foreign financial entry. I therefore expect no relationship between capital account openness and foreign ownership liberalization. I nevertheless control for capital account openness to ensure that in each model, the estimated effect of financial sector size on financial liberalization is independent of its effect on capital account openness. In this way, including

*KAOPEN* as a control variable ensures that the model measures foreign ownership restrictions, not controls on capital movements.

The final control variable captures diffusion through the average of all other countries' foreign ownership restrictions (*AVGLIBERAL*). Several works have recently argued that liberalization is driven via cross-country competition for capital, such that the decision of one country to liberalize spurs others to follow their lead (Elkins et al. 2006; Simmons and Elkins 2004). Via this hypothesis, higher levels of foreign ownership liberalization elsewhere in the world will spur each developing country to undertake further ownership liberalization. As this hypothesis requires repeated observations over time, however, it is only possible to test it on the FEOR data.

### *3.3. Estimation Results: LFBE Data*

While the LFBE data offer the ideal method to test the relationship between banking sector size and limits on foreign bank ownership, data for financial sector size, political regime, capital account openness, and entry limitations are absent for a number of countries. I address these data omissions through multiple imputation (King et al. 2001). The dependent variable *LIMITS* is a binary variable, so I estimate probit regressions for all models. Identification is another concern, especially given the cross-sectional nature of the LFBE data. Research cited previously confirms that countries whose financial sectors have been liberalized to foreign ownership have larger financial sectors. But this bias should work in my favor. If openness causes financial sectors to grow, this should increase the probability that I find no evidence that large financial sectors inhibit liberalization. Nevertheless, to mitigate the possibility that simultaneity will mask the effect of sectoral size on liberalization, I measure independent variables in 1997, the year prior to Barth et al.'s release of their survey.

As my theory applies to emerging markets only, I define the universe of cases as all countries for which Barth et al. have data but which are not members of the Organization for Economic Cooperation and Development (OECD). To ensure that this case selection strategy does not drive the results, I also estimate a model where I include data from Mexico and Turkey, two OECD countries often treated as emerging markets rather than developed economies (Model 2). I also estimate a model where I drop Israel and Singapore, two highly financially open and highly developed non-OECD economies that operate as regional financial hubs (Model 3). A table of summary statistics for the unimputed data, and including the two OECD emerging markets, is available in Table 1.

--- Table 1 about here ---

Regression results appear in Table 2. Results in all models support to the hypothesis that financial sector size in the developing world is positively associated with banking sector liberalization.

--- Table 2 about here ---

In all models, *SIZE* is statistically significant and positive, as expected. There is also a strong relationship between a country's central bank assets as a share of GDP and banking sector liberalization. These results confirm that countries with large banking sectors are significantly more likely to restrict foreign ownership of banks.

Model 4 uses the sample of countries in Model 3, and adds two additional control variables: the variable *CONCENTRATION* described previously, and a measure of government ownership of banks (*GOVTOWN*). Some research suggests that government ownership of banks should be a prime determinant of foreign bank entry restrictions (Barth et al. 2004; La Porta et al. 2000). The results from Model 4 indicate that not only does the extent of government ownership

not significantly predict ownership restrictions, but more importantly, that the results on banking sector size remain consistently strong in this model. The results for *CONCENTRATION* in this model indicate that there is no significant relationship between banking sector concentration and limitations on foreign bank entry.

#### *3.4. Estimation Results: FEOR Data*

As the FEOR dataset contains repeated yearly observations across countries, it warrants different treatment than the LFBE data. The paucity of theoretically-motivated control variables suggests that a conservative strategy is to employ a fixed effects estimator, which estimates country-specific intercepts that capture unobserved country-specific heterogeneity in the determinants of financial liberalization. Additionally, visual inspection of individual panels suggests—consistent with a global trend towards financial opening throughout the developing world—that there is an overall trend in many countries towards increased financial liberalization between 1989 and 2000. There are important exceptions in countries such as Malaysia; nevertheless, to capture this time trend I include a trend variable *COUNTER* that increases by 1 each year after 1989.<sup>4</sup> Finally, policy stickiness means that current levels of liberalization may depend on previous levels of liberalization. I therefore include a lagged value of *LIBERAL* in some models to check that past values do not drive the results.

The possibility of panel dynamics through the lagged dependent variable (LDV) introduces complications. Absent rigorous theoretical priors, there is no compelling reason either to include or ignore LDVs. But by including them in the fixed effects model, I introduce correlation between the error term and the lagged dependent variable, rendering ordinary least squares (OLS) estimates biased and inconsistent. Beck and Katz (2004) argue that in many

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<sup>4</sup> Lagrange multiplier tests do not find evidence of unit roots in most panels.

typical political science applications, the fixed effects LDV estimator performs relatively well in terms of its root mean square error (RMSE). But while the sample of countries in the analysis is rather small ( $n = 19$ ), the number of observations per country is also relatively short ( $t = 10$ ). Where  $t = 10$ , the bias and RMSE of the fixed effects LDV estimator is unclear— $t$  is neither in the range of true panel data where it is very small in comparison to  $n$  and bias is known to be quite large ( $t \leq 5$  in typical applications), nor is it in the range where Beck and Katz (2004) argue that fixed effects LDV is an attractive estimator on RMSE grounds ( $t \geq 20$ ). Hausman's (1978) test of exogeneity strongly rejects the null hypotheses that either a pooled model or random effects model is consistent but more efficient than the fixed effects estimator.<sup>5</sup>

Given this result that unit-specific heterogeneity is a major concern, an alternative modeling strategy is the Generalized Method-of-Moments (GMM) estimator proposed by Arellano and Bond (1991). A serious limitation of the Arellano-Bond estimator is that its consistency comes at the expense of efficiency. It is not clear on asymptotic grounds that the loss of efficiency is worth the gain in consistency. As a conservative estimation strategy, then, I report four types of “baseline” results: fixed effects, fixed effects with a LDV, the Arellano-Bond GMM estimator, and results from a refinement of the GMM estimator often called the “system-GMM” estimator (Arellano and Bover 1995; Blundell and Bond 1998). The fixed effects model risks omitted variable bias by ignoring dynamics—although following Achen (2000), absent a dynamic theory and evidence of non-stationarity, it is not clear that there are any econometric dynamics to miss. The fixed effects LDV model risks an unknown amount of bias through residual correlation between regressors and residuals. The Arellano-Bond dynamic panel estimator risks inefficiency, and the system-GMM estimator attempts to mitigate this concern. For the GMM models, I model the time trend *COUNTER* as predetermined and all

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<sup>5</sup> The test statistic (distributed  $\chi^2$  with 7 degrees of freedom) is 175.62.

other variables as endogenous, and I also calculate the long-term effect of *SIZE* on *LIBERAL*. In the Appendix, I include results from two additional robustness checks, using panel-corrected standard errors (Beck and Katz 1995) and a left-censored Tobit regression. Given that current research has shown the deep fragility of time-series cross-sectional regressions to simple alternative specifications (Wilson and Butler 2007), this battery of specification tests ensures that the findings are not an artifact of the estimation strategy.

Simultaneity still remains an issue for all models, although as argued above, simultaneity bias would actually strengthen my findings. I estimate all models employing one-year lags of independent variables to mitigate this bias. A table of summary statistics is available in Table 3.

--- Table 3 about here ---

Table 4 presents the baseline findings from the FEOR data. The results in all models support to the hypothesis that financial sector size in the developing world is negatively associated with liberalization of foreign equity ownership restrictions.

--- Table 4 about here ---

In all models, the coefficient on financial sector size is negative and highly statistically significant, as expected. Additionally, the coefficient on the ratio of central bank assets to GDP is negative and statistically significant in Models 5 and 6. To estimate the long-run relationship between the *SIZE* and *LIBERAL* for Models 7 and 8, I calculate the long-run parameter estimate as the ratio of the coefficient on *SIZE* and one minus the coefficient on the lagged dependent variable (which measures the speed at which changes in independent variables filter to the dependent variable). In Model 7, this estimate is -.522 (significant at the 99% confidence level), and for Model 8, this estimate is -1.151 (significant at the 95% confidence level).<sup>6</sup>

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<sup>6</sup> Arellano and Bond (1991) note two additional specification tests for their model. These also apply for the system-GMM estimator. The first specification test checks for first- and second-order serial autocorrelation in the residuals:

Results from the control variables are likewise interesting. Regardless of specification, the coefficient on the time variable *COUNTER* is positive and significant, confirming the existing of a cross-country trend towards financial liberalization throughout the late 1980s and 1990s. Rather puzzlingly, the coefficient of the diffusion variable *AVGLIBERAL* is significant and *negative*. That is, controlling for all other explanations, each country was less likely to liberalize foreign ownership restrictions the more other countries had liberalized foreign equity ownership regulations. This is likely an artifact of the inclusion of *COUNTER* in the model. In other estimates (not reported) without *COUNTER* as a control variable, the effect of *AVGLIBERAL* is significant and positive. Other economic and political control variables are insignificant, as was the case for the LFBE data. Such results fail to support the hypothesis that within the sample of developing countries and emerging markets, more wealthy and faster growing countries are more likely to liberalize their equity markets. The results for *POLITY2* suggest that resistance to financial liberalization is common to both democracies and non-democracies. Finally, the results for *KAOPEN* confirm that there is no link between capital account openness and equity market liberalization.

Table 5 shows the results from replications of Models 5-8 with the measure of financial sector concentration as an additional control variable.

--- Table 5 about here ---

Models 9-12 simply add *CONCENTRATION*, and Models 13 and 14 test whether the relationship between *CONCENTRATION* and *SIZE* is interactive. The evidence for *CONCENTRATION* is

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first-order autocorrelation should be present and negative, while second-order autocorrelation should be absent. Tests reject the null hypothesis of no first-order negative autocorrelation ( $p$ -value = 0.021 in Model 5; 0.008 in Model 6) and fail to reject the null hypothesis of no second-order autocorrelation ( $p$ -value = 0.173 in Model 3; 0.126 in Model 4). A second specification test is a modified Sargan test of the validity of the model's overidentifying restrictions. The test statistic, distributed  $\chi^2$ , is 17.153 (84 degrees of freedom) in Model 3 and 19.036 (103 degrees of freedom) in Model 4. Neither can reject the null hypothesis that overidentification is valid. See also Wawro (2002).

mixed. In Models 9 and 10, the estimate of *CONCENTRATION* is negative and highly significant, as expected.<sup>7</sup> Turning to the interactive models, to interpret the coefficients for *CONCENTRATION*, *SIZE*, and their interaction, Figure 1 plots the marginal effect of *SIZE* over the range of values that *CONCENTRATION* takes, along with a confidence interval surrounding each estimate, as obtained from Model 14.

--- Figure 1 about here ---

*SIZE* has a negative and statistically significant effect on equity ownership restrictions at values of *CONCENTRATION* above around .5, but the magnitude of this effect increases only marginally as *CONCENTRATION* increases past that value. In Model 14, the marginal effect of *SIZE* when *CONCENTRATION* = .5 is -.501, and when *CONCENTRATION* = 1, the marginal effect is -.533. This very small degree of variation over the entire range of significance shows that the interactive effects of financial sector size and concentration are weak, and so that the additive representation in Models 9-12 better represents between financial sector size, concentration, and equity ownership liberalization. Also in Models 9-10 and 13-14, several control variables do achieve statistical significance. More democratic countries appear more likely to liberalize equity markets to foreign participation, and wealthier countries appear less likely to liberalize equity markets to foreign participation.

But these results for *CONCENTRATION* and for control variables in the additive model do not hold in either the Arellano-Bond or system-GMM models. In the Arellano-Bond model (Model 11), the results for *CONCENTRATION* are negative and significant as before, but specification tests indicate that the results fail to meet the model's assumptions of negative first-order serial autocorrelation in the residuals.<sup>8</sup> In Model 12, results do barely meet the system-

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<sup>7</sup> Similar results for *CONCENTRATION* were found in replications of Models 5-10 (not reported).

<sup>8</sup> The null hypothesis is no serial autocorrelation; the test's *p*-value = 0.111.

GMM assumptions, but the effect of *CONCENTRATION* is now insignificant—both in the short- and long-term, as are estimates for both *POLITY2* and *GDPPC*. Results from this stringent test accordingly question whether financial sector concentration affects ownership liberalization above and beyond the influence of sector size. Nonetheless, consistent results from *SIZE* in both the short- and long-term reaffirm that restrictions on foreign equity ownership increase as financial sector size increases.

#### **4. Financial Internationalization: Case Study Perspectives**

Despite the robust links I have established between financial sector size and foreign ownership restrictions in the developing world, establishing a causal link to financial sector political pressure requires more focused investigation. For while the use of size as a proxy for political influence has a long history in international political economy research, mappings may not be exact. For this reason, I focus on the cases of Mexico and Indonesia to illustrate my findings and check that the causal pathway I propose obtains. These cases do not themselves test the theory, but closer examination of the qualitative record allows us observe more closely the political dynamics that underlie financial opening in these countries.

The logic of case selection here, therefore, is akin to “on-the-line” model testing advocated by Lieberman (2005). My goal is to investigate cases that fit the model well (low levels of financial liberalization with large and politically powerful financial sectors and very open capital accounts) to ensure that my argument explains why. The cases of Indonesia and Mexico are also useful because a large body of research has chronicled their experiences with financial liberalization before the onset of data in 1989. Moreover, the Mexican case clearly deviates from expectations in the early 1980s, when the regime retreated from capital account openness as a response to the Latin American debt crises. My theory suggests that the financial

sector must have lost political favor during this period, and would have opposed these policies, which is indeed the case.

Finally, Lieberman (2005) advocates selecting cases that vary as much as possible in the explanatory variables. Mexico and Indonesia, though, are similar. To ensure broader variation, I briefly consider the contrasting case of Senegal, which liberalized dramatically to cross-border financial ownership in the late 1990s but had a small and powerless domestic financial sector. The cases also suggest why links between sectoral concentration and policy outcomes are fragile. All three featured relatively high levels of banking sector concentration, but Senegal's financial sector was concentrated because it was so small, whereas Indonesia's and Mexico's were concentrated because of political favoritism heaped upon the financial sector. Scatterplots of *SIZE* by *KAOPEN* and commitments to banking entry liberalization in the 1997 General Agreement on Trade and Services (Mattoo 1999) illustrate how the three countries vary (Figure 2).

#### *4.1. Indonesia*

Indonesia has a long history of capital account openness, beginning shortly after the fall of President Sukarno in 1966.<sup>9</sup> Under Sukarno, both Indonesia's financial sector and the broader economy at large faced extensive controls and regulations. Upon replacing Sukarno, one of General Soeharto's first tasks was to appoint a team of neoliberal economists to oversee Indonesia's integration into the world economy. Early in their tenure, these economic advisors prompted Indonesia to liberalize its capital account to a level nearly unprecedented in the developing world at the time.

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<sup>9</sup> I base the narrative in this section on Bresnan (1993), MacIntyre (1993), Montgomery (1997), Pepinsky (2007), Shin (1989), Sharma (2001), Soesastro (1989), and Winters (1996).

The initial move was feasible in no small part because of simultaneous pressures from the country's ethnic Chinese financiers, whose comparatively wealthy status within the country made them an attractive ally for a developmentalist dictator such as Soeharto. Their mobile financial assets gave them important bargaining leverage over the regime, and this leverage was especially valuable because of their vulnerable political status as non-“indigenous” Indonesians. Haggard and Maxfield (1996), among others, interpret capital account opening as a tool for assuaging the worries of ethnic Chinese financiers, who might have otherwise refused to invest in the economy for fear of being unable to cut their losses in the event of a political setback. At the same time, capital account openness provided these same ethnic Chinese financiers with access to abundant and cheap foreign capital. The other beneficiaries of capital account openness were the regime's own state-run banks, whose role in development financing remained large throughout Soeharto's New Order regime. The New Order's relatively stable political system provided a platform for foreign capital inflows that fostered state banks' rapid growth, allowing them to fund a vast array of development projects.

At the same time that the New Order regime opened Indonesia to cross-border capital flows, though, its leaders embarked on the construction one of the developing world's most impressive edifices of patronage and clientelism. Tight linkages between domestic finance and the regime were instrumental for this task. Public investment banks funneled cash to the regime's cronies in the military and among the ethnic Chinese business community, rewarding loyal supporters with easy access to credit. Other private banks, which developed in the 1980s and early 1990s as central organs in ethnic Chinese financiers' business empires, allowed business moguls to amass substantial funds with which to invest in local business ventures as shadow partners of indigenous entrepreneurs and even the Indonesian military itself. Even

indigenous Indonesian business empires grew to include powerful banking subsidiaries. The regime's ability to deploy credit facilities to its favored allies (and withhold them from potentially troublesome subordinates) allowed it to use financial assets as a tool for regime maintenance. Indonesia's financial markets accordingly supported not only the regime's developmentalist projects and the private interests of ethnic Chinese financiers, but also the very political foundations of the Indonesian state. Capital inflows under the New Order's open capital account policy gave it access to the inexpensive foreign capital necessary to accomplish these goals.

The regime was careful, though, to retain a tight hold over the domestic financial sector. A flood of foreign financial lenders might have threatened the politically valuable banking subsidiaries of both ethnic Chinese cronies and the state—foreign lenders could not provide political protection, but could have offered more favorable terms than domestic lenders ever could have. As a check on this possibility, then, Soeharto's regime retained tight barriers over financial entry into the country. These included a number of preferential credit provisions for domestic bankers, ownership and presence limitations on foreign banking subsidiaries, and high barriers on foreign equity ownership on the Jakarta Stock Exchange which persisted into the 1980s. Each of these fulfilled key political interests among the country's lenders, who were free to intermediate abundant foreign capital at their own discretion.

At the close of the 1980s, facing a serious balance-of-payments crisis, the New Order regime directed a round of deregulation that eliminated a number of the ownership restrictions that it had previously kept in place. Known by its Indonesian acronym of Pakto 88 (for October 1988 Packet), this gave foreign financial institutions new broader access to the country. Yet the specifics of this second round of financial liberalization are instructive. Despite rhetorical

commitments to open stock markets to foreign investors, the regime still placed restrictions on foreign equity ownership (as reflected in the Edison and Warnock measure, which falls below .5 until late 1997). Furthermore, Pakto 88 lifted the previous ban on foreign financial presence outside of the capital city of Jakarta, but as late as 1997 no new foreign banks were permitted to enter the country—only banks whose presence had predated financial deregulation were permitted to open new branches. In fact, despite the far ranging reforms enacted under Pakto 88, its main target was the Indonesian financial sector. The deregulation package further streamlined Indonesian banks' ability to raise funds overseas by abolishing Bank Indonesia's role in approving foreign loans. It also removed ceilings on the amount of funds they could raise overseas, and ended the practice of Bank Indonesia overseeing long-term loans. Sharma (2001) notes that as a result of the strong controls on entry, by 1996 there were just ten foreign banks in Indonesia, as compared to thirty-four joint ventures and 160 fully private domestic Indonesian banks, which has blossomed after Pakto 88. All of these measures had the sum effect of "liberalizing" Indonesia's financial sector, but in a way that protected Indonesian banks' roles as intermediaries between foreign sources of capital and the domestic market.

Indonesian financial institutions' practice of intermediating between foreign capital sources and the domestic market accordingly fulfilled the demands of both Indonesian lenders and the New Order regime. In fact, the lucrative nature of this transaction eventually would lead to the excesses that spawned Indonesia's financial crisis in 1997, as domestic borrowers increasingly neglected to hedge their foreign currency debts against exchange rate movements. By the eve of the Asian Financial Crisis, capital inflows were massive, yet still dwarfed by domestic bank lending. Jomo and Hamilton-Hart (2001) estimate that by 1996, for example, claims on private sector held by deposit money banks were 55% of GDP, while new capital

inflows totaled just 4.8% of GDP. The collapse of the rupiah in summer 1997 would eventually send the country into turmoil, as the Indonesian banking system crumbled, thereby undermining the New Order ability to mobilize funds from the financial sector for political gain.

#### *4.2. Mexico*

Mexico is rather unique among Latin American countries in its long-standing adherence to capital account openness.<sup>10</sup> Capital account openness in Mexico began in the 1920s amidst a situation rather similar to that facing Indonesia in 1965. In a move to placate domestic and international financiers and keep capital from fleeing the country, and faced a stifling amount of foreign debt and massive capital flight, the regime adopted an open capital account policy in order to project credibility for sound economic management. This policy was ultimately successful. Mexico's capital account would remain largely open for nearly six decades, not to be closed again until the Latin American debt crisis of 1982.

As it developed throughout the middle half of the twentieth century, the financial sector progressively gained influence over policy making. This explains the fact that a liberal capital account policy was not matched by liberal foreign ownership and presence laws. Throughout this period, governments forbade foreign banks from entering the Mexican market without meeting increasingly stringent requirements from Banco de México. Those that had already established a commercial presence faced heavy restrictions on their activities, and were “essentially prohibited from engaging in any form of financial intermediation” (Loriaux et al. 1997). This was a direct product of Mexican lenders' pressure on the regime for favorable ownership policies amidst an open capital account. A strong domestic financial sector was also politically useful for the Mexican government. By mobilizing reserve funds held at Banco de

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<sup>10</sup> I base the narrative in this section on Adams (1997), Loriaux et al. (1997), Lustig (1998), Maxfield (1990, 1992), Santín Quiroz (2001), and Valdés Ugalde (1994).

México, governments were able to finance industrialization, which produced economic growth and benefited constituents from organized labor to industrial capital.

So far, the Mexican case confirms the relationship between a large and politically influential banking sector and both capital account openness and restrictions on foreign financial ownership. But the Mexican regime under the PRI, unlike Indonesia's New Order, was a populist regime that at least until the mid-1980s openly embraced organized labor and used it as one of its bases of political support. When the Latin American debt crisis hit Mexico in late 1981, the regime turned against the Mexican financial sector in order to protect the fortunes of labor and industrial capital. President José López Portillo's famous September 1, 1982 speech that announced the nationalization of Mexican banks and the imposition of tight exchange controls likened domestic bankers to "rats," and blamed them for the country's industrial hardship and growing unemployment. The decision to close Mexico's capital account to inflows and outflows was widely popular among industrialists and laborers, but heavily resisted by domestic lenders, as the theory here would predict. Bank nationalization was likewise strongly condemned by domestic lenders. These decisions show that financial sector size does not correspond exactly to political influence in the developing world, but it is reassuring that interest group pressures continued to operate as expected by the theory.

With the end of López Portillo's term in office and the onset of the term of his successor Miguel de la Madrid Hurtado, financial sector pressure began to bear fruit. Banks were gradually reprivatized in the latter half of the 1980s, a process which culminated in 1990. At the same time, the capital account was reopened, to the delight of financial sector actors eager to access foreign capital. But even as banks were reprivatized and the capital account reopened, pressure from lenders bore fruit to ensure that liberalization would not extend to foreign

ownership, but only to foreign capital inflows. Under the 1990 banking law which finalized privatization, foreign banks were expressly prohibited from intermediating in the country's domestic financial sector. In addition to foreign entry restrictions, the privatization exercise restricted the amount of newly privatized Mexican financial institutions that foreigners could own. These policies reflect the strong interest group pressure that Mexican lenders were able to bring to bear on the government.

The policy shifts that took place in the second half of de la Madrid's term and later under President Carlos Salinas de Gortari emphasized privatization, and returned political power to the Mexican banking sector that had been so assaulted in the final months of the López Portillo administration. Under Salinas especially the regime turned to embrace the financial sector as a key coalition partner. But the foreign investment law of December 1993—widely seen as emblematic of Salinas' move towards financial liberalization—still mandated ownership maxima of 30% foreign equity and insurance market participants and 49% for other financial institutions such as insurance houses (Adams 1997).

At the same time, in the early 1990s negotiations with the United States over the North American Free Trade Agreement gave new external impetus to Mexican financial sector liberalization. The United States pressured Salinas to allow American banks to enter the Mexican market. Nevertheless, pressure from the newly re-ascendant Mexican lenders meant that amidst almost total trade and capital account opening, foreign financial institutions *still* faced substantial restrictions in entry, market share, and equity ownership. Under the final NAFTA agreement, foreign banks could still not open new branches in Mexico, were restricted to 30% capital ownership in commercial banks, and their commercial activities were restricted to no more than fifteen percent of the market as late as 1999 (NAFTA 1994). Such measures

reflected the political influence that Mexico's large financial sector was able to marshal against the Salinas administration, and protected Mexican banks from foreign competition while welcoming foreign capital inflows.

#### *4.3. A Contrasting Case: Senegal*

If Indonesia and Mexico demonstrate the consequences of a large and politically powerful financial sector, Senegal illustrates the consequences of a weak financial sector for subsequent liberalization decisions. While stronger than most other West African economies, by global standards Senegal's financial sector is so weak that it can neither pressure Senegalese governments to protect it nor provide sufficient financing for the country's corporate sector. Indeed, today large Senegalese firms seek direct foreign financing rather than using domestic banks (IMF 2005). This is because the domestic financial sector is simply incapable of meeting firms' credit needs, and is unable to pressure the government to protect it from foreign competition.

Financial internationalization in Senegal began after the collapse of the CFA franc in 1994. The subsequent years saw extensive liberalization, which accompanied a broad range of sectoral reforms under the auspices of the IMF. Its commitment to bank deposit liberalization as well as foreign bank presence under GATS was substantial. A continued complaint from both the IMF and domestic companies, though, has been the lack of a real domestic financial sector that can serve Senegalese firms. In raising funds for the privatization of the parastatal groundnut enterprise SONACOS, for example, the country raised funds directly from foreign banks (Soumaré 2002). Perhaps ironically given the near impossibility of creating a financial sector that can compete effectively with foreign banks without substantial protection, even the IMF has lamented the near absence of local Senegalese financial intermediation (Government of Senegal

2005). At the same time, restrictions on cross-border capital movements have been eased moderately but remain strong. Absent pressure from a large financial sector that can successfully meet the needs of domestic borrowers and pressure the government for protection, Senegalese governments have open Senegal's financial markets to foreign participation to meet financing needs that the domestic financial sector cannot.

## **5. Conclusion**

A wealth of economic theory suggests that financial internationalization has sharp distributional consequences in the developing world. Current research, though, has provided few clear links between interest group pressures and policy change. A likely explanation is because measures of financial internationalization fail to distinguish between various components of financial internationalization—debt versus equity flows, inward flows versus outward flows, and movement versus ownership of capital assets—over which interest groups likely have very different preferences. Focusing tightly on this last distinction, I show in this paper that large financial sectors are robustly associated with more restrictions on foreign bank entry and more restrictions on foreign equity ownership in the developing world. This result is consistent with both qualitative and quantitative findings that large financial sectors pressure governments for more capital account openness. I argue that the mechanism linking the two is capital's fungibility: lenders in the developing world demand access to foreign capital—which lowers their costs of borrowing—without having to compete with it.

This perspective moves beyond the predictions of the dominant frameworks for analyzing open economy politics: the mobile factors approach exemplified in Rogowski (1989), and the sector-specific factors approach exemplified in Gourevitch (1986). Neither approach can explain the pattern of financial sector lobbying for free movement but restricted entry of international

capital. Yet this is not simply another argument that “finance is special.” It suggests that preferences over globalization strategies follow the positions that firms take in global production and distribution chains. Within other sectors, firm-level preferences over movement and entry of foreign goods will differ between producers and distributors. From the 1960s to the 1990s in Indonesia, for example, the positions of a small number of trade intermediaries hamstrung the transition from trade openness to true trade liberalization. While open to trade with countries like Japan, large intermediaries such as PT Astra International constructed elaborate marketing and distribution networks dependent on their status as sole legal importers of automobiles and industrial equipment. Far from rare, trade intermediaries handle a substantial portion of trade in many emerging market economies (Schröder et al. 2003), and import-licensing is prevalent in a number of sectors and in virtually all countries (OECD 2003). Like financiers, trade intermediaries benefit from their status as importers to access foreign goods, but also as sole distributors to avoid competing with foreign firms. Like in finance, such intermediation can arise naturally from transactions costs, or more perniciously as the result of lobbying for political protection. Finance only differs in that by their nature all lenders are distributors. In the developing world, intrasectoral cleavages within import-competing industries should arise between producers and distributors, the former resisting all trade openness and the latter favoring openness without trade liberalization.

There is clearly more work to be done on this topic. As noted previously, additional theoretical determinants of financial ownership liberalization in the developing world remain underspecified. In results not reported here, I explored whether trade openness as measured by the sum of imports and exports as a ratio of GDP—often held to influence capital account liberalization—played any role in liberalization, and again found no link. Such findings confirm

the notion that different aspects of financial internationalization have very different cross-national determinants. This should accordingly push scholars of international finance more closely to examine the intricate politics of financial liberalization in the developing world.

Perhaps more importantly, though, the empirical strategy here has focused on the role of lenders in pressuring governments for both capital account openness and lending restrictions. Unmeasured is the pressure brought to bear by borrowers, whose preferences should operate at cross-purposes from lenders: they should demand greater competition in the financial sector to decrease their cost of capital *along with* cross-border capital inflows. Future research can explore the extent to which such demands countermand those of lenders. Qualitative evidence would suggest, though, that in many developing countries tight corporate links between lenders and domestic borrowers lead the latter to mitigate demands for foreign financial entry. Additionally, borrowers may resist the due diligence of foreign lenders, who may be less likely to lend to politically-connected firms than domestic lenders. These are areas of research that will benefit from closer attention to interest pressures and financial politics in the developing world.

## **6. Appendix**

In this appendix I present results from two additional robustness checks to ensure that the baseline results of the FEOR data are consistent with alternative estimation strategies. The first deals with panel-corrected standard errors (PCSEs), which correct for serial correlation and heteroskedasticity in residuals (Beck and Katz 1995). I re-estimate models with PCSEs in addition to country dummies, with and without a one-period panel-specific autoregressive process in place of the lagged dependent variable. The second robustness test relaxes assumptions about the distribution of the dependent variable, for the ratio of equity markets

available to foreigners to the total size of the equity market cannot extend below zero.<sup>11</sup> This is problematic in the event that the index does not capture additional theoretically possible restrictions on equity market ownership, meaning that there is an unobserved dependent variable  $Y^*$  where the observed dependent variable  $LIBERAL = 0$  iff  $Y^* \leq 0$ . I report three tobit models: a random-effects tobit model and two unconditional fixed effects tobit models, although results from the unconditional fixed effects tobit model should be interpreted extremely carefully, as such estimators are inconsistent where panels are of finite length (see Maddala 1987). But recent research suggests that bias in slope coefficients becomes quite small as panel length increases beyond  $t = 5$ , and that bias in standard errors is largely a function of the degree of censoring, which in this study is far lower (5/175 or 2.86%) than even in standard Monte Carlo studies (typically 40% or greater) (Greene 2004).

Table 6 contains results from these robustness tests. Results for both sets of models are consistent with earlier results.

--- Table 6 about here ---

In these models as well, the effects of *SIZE* and *CBAGDP* on equity market liberalization are negative and highly statistically significant. The estimated effects of control variables are not statistically distinguishable from zero with the exception of *GROWTH* in Model 15, while the time trend variable *COUNTER* is positively and significantly associated with equity market liberalization, and the diffusion variable *AVGLIBERAL* is negatively and significantly associated with equity market liberalization, as before. The results hold regardless of the inclusion of lagged values of *LIBERAL*. Despite the necessary caveats about interpreting results from the fixed effects models with LDVs and in the tobit models, these results are powerful evidence that

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<sup>11</sup> Due to the correction for asymmetric price shocks, it is possible for the index to exceed 1, and in several cases it does.

larger financial sectors in the developing world inhibit the liberalization of equity markets to foreign participation.

**Table 1: Summary Statistics, LFBE Data**

<b>Variable</b>	<b>Mean</b>	<b>SD</b>	<b>Min</b>	<b>Max</b>	<b>N</b>
<i>LIMITS</i>	0.342	0.481	0	1	38
<i>SIZE</i>	0.845	0.161	0.195	1	52
<i>CBAGDP</i>	0.065	0.085	0	0.527	47
<i>CONCENTRATION</i>	0.704	0.202	0.317	1.000	52
<i>GOVTOWN</i>	0.259	0.248	0	0.800	50
<i>POLITY2</i>	2.772	6.601	-10	10	57
<i>KAOPEN</i>	0.354	1.516	-1.767	2.603	47
<i>GDPPC</i>	6765.648	6309.183	477.551	28764.230	58
<i>GROWTH</i>	2.489	4.321	-8.194	13.856	58

**Table 2: Results from LFBE Data<sup>a</sup>**

	<b>Model 1</b>	<b>Model 2</b>	<b>Model 3</b>	<b>Model 4</b>
<i>C</i>	-5.879** (2.632)	-4.962** (2.227)	-6.652** (2.552)	-7.550** (2.958)
<i>SIZE</i>	5.637* (2.978)	4.442* (2.524)	5.994** (2.880)	7.014** (2.827)
<i>CBAGDP</i>	10.854* (5.589)	9.455** (4.300)	12.585*** (4.795)	14.904*** (4.588)
<i>CONCENTRATION</i>				-1.020 (1.164)
<i>GOVTOWN</i>				1.661 (1.173)
<i>POLITY2</i>	-0.023 (0.034)	-0.008 (0.032)	-0.010 (0.039)	-0.010 (0.043)
<i>KAOPEN</i>	-0.037 (0.167)	0.136 (0.196)	-0.013 (0.212)	0.053 (0.254)
<i>GDPPC</i>	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000* (0.000)
<i>GROWTH</i>	-0.067 (0.060)	-0.064 (0.054)	-0.069 (0.050)	-0.071 (0.058)
<i>Sample</i>	Non-OECD	Non-OECD, Turkey, Mexico	Non-OECD, no Israel, Singapore	Non-OECD, no Israel Singapore

<sup>a</sup> Cells contain parameter estimates with robust standard errors in parentheses. \* = statistically significant at  $\alpha < .1$ . \*\* = statistically significant at  $\alpha < .5$ . \*\*\* = statistically significant at  $\alpha < .01$ .

**Table 3:** *Summary Statistics, FEOR Data*

<b>Variable</b>	<b>Mean</b>	<b>SD</b>	<b>Min</b>	<b>Max</b>
<i>LIBERAL</i>	0.568	0.305	0	1.120
<i>SIZE</i>	0.846	0.143	0.395	0.999
<i>CBAGDP</i>	0.081	0.093	0.001	0.581
<i>POLITY2</i>	4.850	5.572	-8	10
<i>KAOPEN</i>	-0.185	1.316	-1.752	2.623
<i>GDPPC</i>	6935.414	3731.841	1634.713	17056.14
<i>GROWTH</i>	2.026	4.789	-17.762	15.330
<i>AVGLIBERAL</i>	0.544	0.118	0.299	0.755

**Table 4: Baseline Results from FEOR Data<sup>a</sup>**

<b>Variable</b>	<b>Model 5</b>	<b>Model 6</b>	<b>Model 7</b>	<b>Model 8</b>
<i>C</i>	1.991*** (0.399)	1.203*** (0.363)	1.123** (0.538)	1.264*** (0.469)
<i>SIZE</i>	-0.796*** (0.258)	-0.516** (0.201)	-0.379** (0.186)	-0.731** (0.335)
<i>CBAGDP</i>	-1.37** (0.623)	-0.849** (0.416)	-0.286 (0.496)	-0.672 (0.533)
<i>POLITY2</i>	0.001 (0.003)	0.001 (0.003)	0.007 (0.004)	0.001 (0.006)
<i>KAOPEN</i>	-0.001 (0.012)	-0.004 (0.013)	-0.004 (0.014)	0.005 (0.011)
<i>GDPPC</i>	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
<i>GROWTH</i>	-0.002 (0.002)	-0.001 (0.001)	0.000 (0.002)	-0.003 (0.002)
<i>AVGLIBERAL</i>	-2.288*** (0.747)	-1.204** (0.557)	-1.196** (0.539)	-1.258** (0.554)
<i>COUNTER</i>	0.099*** (0.025)	0.054*** (0.02)	0.064** (0.025)	0.061*** (0.021)
<i>L.LIBERAL</i>		0.404** (0.18)	0.276 (0.187)	0.365** (0.182)

<sup>a</sup> Cells contain parameter estimates with standard errors in parentheses. Models 5 and 6 estimated via OLS with fixed country effects. Model 7 estimated via the Arellano-Bond GMM estimator. Model 8 estimated via Arellano-Bover/Blundell-Bond GMM estimator. All models report robust standard errors. \* = statistically significant at  $\alpha < .1$ . \*\* = statistically significant at  $\alpha < .5$ . \*\*\* = statistically significant at  $\alpha < .01$ .

**Table 5: FEOR Results with Financial Sector Concentration<sup>c</sup>**

	<b>Model 9</b>	<b>Model 10</b>	<b>Model 11</b>	<b>Model 12</b>	<b>Model 13</b>	<b>Model 14</b>
<i>C</i>	2.144*** (0.441)	1.763*** (0.435)	1.310** (0.614)	1.408* (0.727)	2.133*** (0.482)	1.726*** (0.529)
<i>SIZE</i>	-0.643*** (0.173)	-0.516*** (0.178)	-0.387* (0.210)	-0.856* (0.477)	-0.630 (0.482)	-0.468 (0.512)
<i>CONCENTRATION</i>	-0.316*** (0.088)	-0.266*** (0.083)	-0.209* (0.116)	-0.138 (0.153)	-0.301 (0.485)	-0.213 (0.495)
<i>SIZE × CONCENTRATION</i>					-0.018 (0.627)	-0.066 (0.620)
<i>CBAGDP</i>	-0.842** (0.423)	-0.659* (0.392)	-0.129 (0.493)	-0.658 (0.797)	-0.842** (0.422)	-0.657* (0.391)
<i>POLITY2</i>	0.005* (0.003)	0.005* (0.003)	0.005 (0.003)	0.003 (0.007)	0.005* (0.003)	0.005* (0.003)
<i>KAOPEN</i>	-0.006 (0.012)	-0.006 (0.013)	-0.021 (0.013)	-0.010 (0.011)	-0.006 (0.012)	-0.006 (0.013)
<i>GDPPC</i>	0.000*** (0.000)	0.000*** (0.000)	0.000 (0.000)	0.000 (0.000)	0.000** (0.000)	0.000*** (0.000)
<i>GROWTH</i>	-0.001 (0.002)	-0.001 (0.002)	0.000 (0.002)	-0.002 (0.002)	-0.001 (0.002)	-0.001 (0.002)
<i>AVGLIBERAL</i>	-1.841** (0.789)	-1.405* (0.737)	-1.063** (0.479)	-1.197** (0.562)	-1.841** (0.793)	-1.405* (0.740)
<i>COUNTER</i>	0.080*** (0.025)	0.062** (0.024)	0.057*** (0.021)	0.057*** (0.021)	0.080*** (0.025)	0.062** (0.024)
<i>L.LIBERAL</i>		0.172 (0.170)	0.204 (0.200)	0.342* (0.192)		0.172 (0.172)

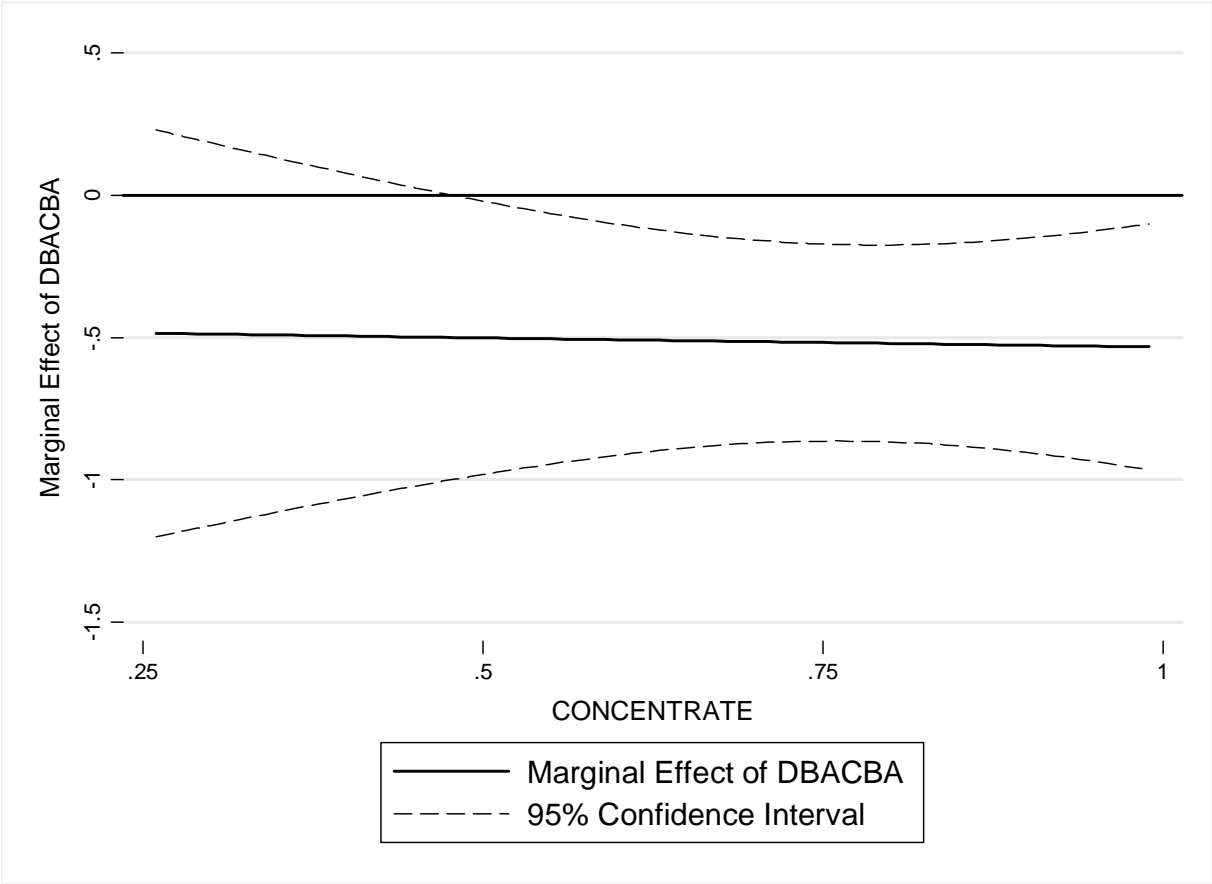
<sup>c</sup> Cells contain parameter estimates with standard errors in parentheses. Models 9-10 and 13-14 estimated via OLS with fixed country effects. Model 11 estimated via the Arellano-Bond GMM estimator. Model 12 estimated via Arellano-Bover/Blundell-Bond GMM estimator. All models report robust standard errors. \* = statistically significant at  $\alpha < .1$ . \*\* = statistically significant at  $\alpha < .5$ . \*\*\* = statistically significant at  $\alpha < .01$ .

**Table 6: Robustness Tests for FEOR Data<sup>b</sup>**

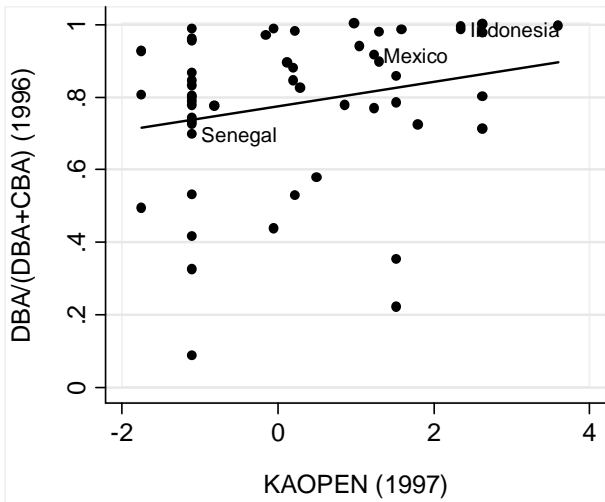
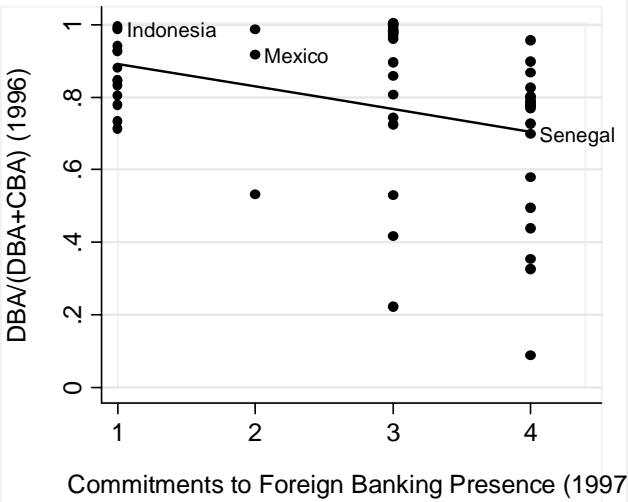
	<b>Model 15</b>	<b>Model 16</b>	<b>Model 17</b>	<b>Model 18</b>	<b>Model 19</b>	<b>Model 20</b>
<i>C</i>	2.249*** (0.406)	1.373*** (0.350)	2.066*** (0.240)	1.992*** (0.269)	2.298*** (0.263)	1.404*** (0.271)
<i>SIZE</i>	-0.796*** (0.128)	-0.516*** (0.128)	-0.684*** (0.138)	-0.742*** (0.199)	-0.804*** (0.191)	-0.52*** (0.176)
<i>CBAGDP</i>	-1.37*** (0.251)	-0.849*** (0.209)	-1.546*** (0.354)	-1.228*** (0.344)	-1.331*** (0.332)	-0.804** (0.307)
<i>POLITY2</i>	-0.001 (0.017)	-0.004 (0.019)	0.010 (0.010)	0.002 (0.004)	0.001 (0.004)	0.001 (0.004)
<i>KAOPEN</i>	0.001 (0.003)	0.001 (0.003)	0.001 (0.003)	0.002 (0.011)	-0.001 (0.011)	-0.004 (0.010)
<i>GDPPC</i>	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
<i>GROWTH</i>	-0.002* (0.001)	-0.001 (0.001)	0.000 (0.001)	-0.003 (0.002)	-0.002 (0.002)	-0.001 (0.002)
<i>AVGLIBERAL</i>	-2.288*** (0.59)	-1.204* (0.641)	-1.516*** (0.385)	-2.653*** (0.531)	-2.365*** (0.495)	-1.25*** (0.473)
<i>COUNTER</i>	0.099*** (0.02)	0.054** (0.021)	0.074*** (0.013)	0.109*** (0.018)	0.103*** (0.017)	0.057*** (0.016)
<i>L.LIBERAL</i>		0.404** 0.169				0.409*** (0.062)

<sup>b</sup> Cells contain parameter estimates with standard errors in parentheses. Models 15-17 estimated via OLS with unconstrained fixed country effects (country intercepts suppressed for presentation), and reporting panel-corrected standard errors. Model 17 estimated with a panel-specific autoregressive process. Models 18-20 estimated via left-censored tobit. Model 18 estimated with random effects. Models 19 and 20 estimated with unconstrained fixed country effects (country intercepts suppressed for presentation). \* = statistically significant at  $\alpha < .1$ . \*\* = statistically significant at  $\alpha < .5$ . \*\*\* = statistically significant at  $\alpha < .01$ .

**Figure 1:** Marginal Effect of SIZE on LIBERAL by Values of CONCENTRATION



**Figure 2:** Mexico, Indonesia, Senegal



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