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**EMERGING MARKET
FINANCE: NEW
CHALLENGES AND
OPPORTUNITIES**

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PART I

AN OVERVIEW

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CHAPTER 1

EMERGING MARKET FINANCE: NEW CHALLENGES AND OPPORTUNITIES

Bang Nam Jeon and Ji Wu

Emerging economies have faced new challenges and opportunities in banking and finance in the midst of increasing uncertainty in the post-crisis era. First, global banking continues to play an important role in affecting the competitiveness and efficiency of the domestic banking sector and the direction and magnitude of international capital flows. The growing presence of foreign banks in emerging economies has raised various concerns about their role in undermining the efficiency of host country monetary policy and banking stability, increasing vulnerability in banking and financial markets, and expanding spillover effects and contagion of foreign shocks from advanced economies to emerging markets. Second, stock markets in emerging economies have experienced increasing volatility and diverging market performances due to increasing policy uncertainty in advanced economies, multifactor determinants of the stock market pricing mechanism and herd (or adverse herding) behavior of stock market investors during crisis as well as post-crisis periods. Third, firms in many emerging markets have also been challenged by capital structure disruptions and the collapse of trade finance during crisis as well as post-crisis periods. In order to maintain sustainable long-term economic growth of developing economies and emerging markets and to expand opportunities to all participants in the path and processes to economic development, inclusive economic development strategies are called. This objective can be achieved through the enhancement of social and financial inclusion by allowing equal and easy access to essential financial services for the broader population, including low-income households and small- and medium-sized enterprises.

This 21st volume of *International Finance Review*, with a specific focus on *Emerging Market Finance: New Challenges and Opportunities*, aims to address

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these challenges and opportunities in global banking, stock market behaviors, and inclusive growth strategies facing emerging markets. This volume consists of four parts: An Overview (Part I), Global Banking Activity, Risk and Contagion (Part II), Stock Market Behavior in Emerging Economies (Part III), and Global Financing for Firms and Financial Inclusion (Part IV).

In Part I, we, the volume editors, provide a summary of this volume and highlight the most important contributions of each chapter.

Part II addresses global banking activities, bank risk and contagion of international financial shocks in emerging economies. Oskar Kowalewski examines how foreign bank branches affect lending by domestic – foreign and state-owned – banks in the Central, Eastern, and Southeastern European (CESEE) countries where foreign bank penetration ratios are very high, compared to other regions in the world economy. Using bank-level panel data from the 17 CESEE countries for the period from 1995 to 2015, the author finds that increased activity of foreign bank branches negatively affects lending by foreign banks and state-owned banks in the host economies. The author attributes this finding to the crowding-out effect of foreign bank branches on foreign banks, including mostly foreign bank subsidiaries, since the two different types of foreign banks compete for the same type of clientele in the host banking markets. This finding on the concerning impact of foreign bank branches on the domestic banking sector in the host emerging countries where foreign banks have penetrated very actively will provide an important point of consideration to monetary authority and bank regulators in those countries when designing their policies on foreign banks.

The Asian banking sector has faced the challenge of a recent rise of non-performing loans (NPLs). Using a dynamic panel model, Junkyu Lee and Peter Rosenkranz investigate the major determinants of the recent buildup of NPLs, and how the NPLs have affected financial variables and the real economy in selected Asian economies. They find that rapid credit growth and excessive bank lending have contributed to the Asian NPL accumulation, and rising NPLs have had an adverse impact on economic growth, credit supply, and the unemployment rate in the Asian economies. These findings provide useful implications for monetary authorities and bank regulators to deal with this recent challenging issue on the excessive buildup of NPLs in the Asian banking sector.

Hongyi Chen, Jianghui Chen and Gaofeng Han study banks' loan pricing behavior in China. Using bank-level data from 2003 to 2013 in China, they present various evidence that banks take into account corporate default risk in determining their loan pricing to borrowing firms. This evidence is found to be more conspicuous for borrowers of non-state-owned enterprises, small-size bank lenders and borrowers from less government-supported industry sectors. These consistent findings seem to provide a very useful lesson for monetary authorities and policy-makers for their efforts in moving toward more market-based banking and financial systems in emerging economies including China. The Chinese banks have increased their market entry into Russia since the early 1990s. Ekaterina Serbina explains the main strategies of market expansion of Chinese banks in Russia and discusses the opportunities for their expanding cooperation with Russian regional banks in the future. As foreign banks expand their operations

globally, the literature has reported that foreign banks play an important role in transmitting financial shocks from advanced economies to emerging host economies through cross-border lending and internal capital markets.

Using Indonesia as an example, Yuki Masujima presents consistent evidence that shocks to a parent bank in the home country are transmitted to its foreign branches in the emerging host economy, Indonesia. He shows that this cross-border financial shock transmission is carried out through the foreign banks' internal capital market transactions by affecting foreign banks' lending activity, especially foreign currency lending. Using bank-level and macroeconomic level data from another emerging Asian market, South Korea, during the period of 2000Q1–2016Q2, Bang Nam Jeon, Hosung Lim and Ji Wu examine spillover effects of global monetary shocks from parent bank home countries to their foreign bank branches in Korea. They present consistent evidence that foreign bank branches in Korea respond consistently to changes in monetary policies in their parent bank home countries (mainly, the United States and the Euro area) in the provision of their foreign currency loans in Korea with a one quarter (three months) time lag. One of the important policy implications of this study is that the recent divergent developments of monetary policy in the United States and the Eurozone countries are expected to generate mixed and confusing effects with a certain time lag on domestic credit and foreign currency loans provided by foreign banks as well as on the direction of cross-border banking flows in Korea.

Part III deals with various empirical evidences on changing stock market behavior in emerging markets as well as in advanced markets. Thomas C. Chiang examines how changes in US monetary policy uncertainty and fiscal policy uncertainty affect stock returns in G7 countries. Using monthly data from January 1998 to December 2018, the author presents evidence that national stock returns are affected negatively from increasing US monetary and fiscal policy uncertainties. These findings seem to provide very useful implications to investors and policy-makers in emerging markets to take into account international spillovers of monetary and fiscal policy uncertainties from advanced economies for their investment decisions or macroprudential policy designs. Using daily stock returns from the major emerging markets – namely, Brazil, China, Mexico, and Turkey – during the period of 2002–2018, Ihsan Erdem Kayral, Hilal Merve Alagoz and Nisa Sansel Tandogan show an increasing level of volatility and its duration until a new equilibrium is recovered during the crisis period. They also show that the effect of negative shocks in each of the national stock markets is more profound than the effect of positive shocks.

Using monthly return data during the period from November 1995 to October 2015, Dazhi Zheng, Thomas C. Chiang and Edward Nelling extend the multifactor model of stock market returns from traditional three-factor and five-factor models (à la Fama and French) to the eight-factor model by incorporating the market risk premium, size, book-to-market, profitability, investment, momentum, price-to-earnings ratio and dividend yield. They show that the extended eight-factor model is superior to the conventional models in explaining the variation of stock returns, and even more so during crisis periods in each of the selected national stock markets in Asia. Ahmed Bouteska examines the dynamic

herding behavior of Tunisian investors in the Tunisia stock market during the period of 2007–2018. The author reports that Tunindex daily return data shows that surprisingly, herding is indeed not present in the Tunisian stock market during the sample period, including the turmoil 2011–2013 period of the Tunisian Jasmine Revolution. The author conjectures that this adverse herding behavior in the Tunisian stock market is partly due to restrictive regulations, the prevalence of strict microstructural system, and the virtually stagnant market activity in the Tunisian markets during the revolution period.

Part IV covers various structural and long-term issues that face emerging financial markets. One of the serious, but still puzzling, consequences of the global financial crisis of 2007–2008 has been the so-called “great trade collapse.” JaeBin Ahn proposes a theory model of trade finance and argues that the crisis-disturbing trade financing system and risk-enhancing nature of the use of letters of credit in international transactions exacerbated the trade collapse during the financial crisis period. The author’s model also shows that banks maintain a lower precision screening test for foreign firms than for domestic firms. An important policy implication of the study is that the rebuilding of trade finance by the global banking system is essential to prevent global trade from suffering another round of trade collapse in the future.

In emerging economies in which financial markets are still developing and the implementation of corporate governance principles are limited, firms face challenges on how to determine their optimal choice of capital structure. Stefan Cristian Gherghina, Georgeta Vintilă, and Diana Alexandra Toader attempt to identify the most relevant factors in determining firms’ capital structure, measured by the ratio of total debt to equity or to total assets. Using firm-specific panel data during 2014–2018 for public companies listed in the Bucharest Stock Exchange in Romania, the authors find that returns on invested capital, dividend payout ratio and liquidity ratio all negatively affect capital structure, while return on assets has an ambiguous impact on capital structure. Since the capital market in Romania is not fully developed yet and the main financing method of Romanian firms is the bank loan, managers of Romanian firms face limited and inflexible capital structure options. Deepening financial structure, diversifying sources of financing and enhancing social and financial inclusion should be essential parts of the major long-term policy objectives for financial regulators and macroeconomic policy-makers in emerging economies.

Peterson K. Ozili surveys various conditions for optimal financial inclusion which is defined as the process of granting access to basic financial services, particularly to low-income households and individuals. The author argues that basic financial services should be offered to people at an optimal price which will encourage the supply of financial services on a continual basis. For the sustainable financial and economic growth of developing and emerging economies, in addition to financial inclusion, social inclusion is essential by enabling all individuals and economic agents to take part in jobs, education and training, and medical services, among others. Iustina Alina Boitan and Emilia Mioara Câmpeanu study the relationship between social inclusion patterns and economic development in selected EU countries. Using a cluster analysis and panel data estimations,

they present empirical evidence that education attainment and employment opportunities play an important role in achieving sustainable economic development in 28 EU countries during the period of 2007–2018 at the population level.

This special issue of the *International Finance Review* will be a useful reference for the various challenges and opportunities of emerging market finance and serve as a rich source of discussion and debate on the issues of emerging market finance to academicians, practitioners, financial market participants, and policy-makers in emerging markets.

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