Trade in Financial Services

Professor Kevin Davis

Research Director, Australian Centre for Financial Studies

www.australiancentre.com.au

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ABSTRACT

This paper attempts to provide an (incomplete) overview of some of the recent research on financial markets and the economy which is relevant for identifying appropriate policies towards trade in financial services. It also provides some commentary on types of policy measures and methods for assessing the ultimate success of such policies.

1. *Introduction*

There is a large empirical literature examining the link between development of the finance sector and economic development. Much of it supports a positive causal link running from financial development as a facilitator of economic growth and development. Levine (2005) in a comprehensive review of the literature on "finance and growth" argues that a causal link from financial sector development to economic growth is well established, and Sylla (2006) makes a similar observation. This provides a rationale for policies to support the development of the financial sector, one aspect of which is policy to increase the involvement of foreign financial institutions and to grow trade in financial services. At the same time the importance of the stage of economic development on the types of financial services needed or demanded should not be forgotten, and this may be relevant to the types of policies considered.

Unfortunately, the specific characteristics of financial sector development which are beneficial to economic growth are not well established. Wachtel (2003) noted "the research does not yet tell us enough about development strategies and processes. It provides little in the way of rigorous guidance about how best to develop the financial sector." Since then there has been a growth in the number of studies which provide some evidence on the mechanisms by which financial development and increased trade in financial services affect economic development.

Following the Global Financial Crisis, there has been a reassessment of the social value of a liberated financial sector – with the importance of developing "crisis-proof" structures a major consideration. Thus policy makers should design financial sector policies with an objective of achieving a desirable financial sector structure. It is by no means apparent that a free market evolutionary approach will lead to a desirable structure – particularly given the widespread existence of government implicit guarantees and other distortions.

Over recent years there has been some questioning about the extent to which financial sector growth is beneficial to economic growth and development. Rosseau and Wachtel (2008) argue that the "impact of financial deepening on growth is not as strong with more recent data as it appeared in the original panel studies with data for the period from 1960 to 1989" and that "financial deepening has a positive effect on growth if not done to excess [ie if financial crises are avoided]".

Several papers have recently re-examined the cross country evidence on finance and growth (Arcand et al, 2012, Cecchetti and Kharroubi, 2012) and conclude that the beneficial effects of more finance cease and become adverse when the ratio of private credit to GDP exceed 100 per cent and finance sector employment exceeds 3.5 per cent of the labour force. Beck, Degryse and Kneer (2012) "find that intermediation activities increase growth and reduce volatility in the long run. An expansion of the financial sectors along other dimensions has no long-run effect on real sector outcomes."

In many developed economies, it could be argued that the point of continuing benefits from financial sector expansion was reached some time ago, and that there has been a switch in attitude from viewing "finance as the handmaiden of industry" to an end-product in itself. The financial sector performs very valuable core economic functions[1], but there is also much trading and dealing activity and miss-selling of financial products and services whose social value can be debated.

These comments suggest the need for careful design of policies towards financial sector development, including thorough cost-benefit analysis of the merits of alternative policies. "Opening up" of financial sectors to foreign competition can bring substantial benefits, and with the progress of modern technology enabling long-distant financial services provision perhaps cannot be avoided. More generally with increasing international trade, there is accompanying need for

[1] Merton (1995) provides an overview of such functions which include: Payments systems for the exchange of goods and services; Mechanisms for the pooling of funds to undertake large-scale indivisible enterprise; Ways to transfer economic resources through time and across geographic regions and industries; Way to manage uncertainty and control risk; Generation of price information which helps coordinate decentralized decision-making in various sectors of the economy; Mechanisms for dealing with asymmetric information problems when one party to a financial transaction has information that the other party does not.

financial services provision. For countries in the APEC region, there is a need to focus both on the importing and exporting of financial services.

This research indicates that it is important to understand more about the link between finance and economic growth and development if good policies are to be found. And because trade in financial services is an important component of financial sector growth, the message applies there also.

In the subsequent section the types of trade in financial services are considered, and implications for how they contribute to financial sector growth are considered. This suggests that cross border expansion by foreign financial institutions is the main component of trade in financial services, such that a consideration of their impact on domestic financial sectors is important to understand. However, the rapid strides in telecommunications and electronic technological, is creating opportunities for new business models which also raise issues regarding other channels of financial services trade.

2. *Types of Trade in Services*

Four modes of trade in financial services are generally identified.

- Provision of financial services from an offshore location – this has typically been seen as problematic, because financial services are a flow which requires some degree of ongoing contact between the parties. But there is less reason to believe that the sale of financial products (deposits, loans, insurance coverage) cannot transcend national boundaries. Moreover, modern telephony and electronic communications are rapidly changing the boundaries between tradable and non-tradable goods and services. Nevertheless, the volume of trade in financial services as captured by national accounts data is very small.
- Provision of financial services to foreigners currently in the host country – as tourism continues to grow, the opportunity for provision of some financial services increases
- Provision of financial services to locals by foreigners temporarily located in the host country (advisory services is one such example).
- Establishment of operations in a foreign country – such as by branch, subsidiary, joint venture etc. This is generally the most common approach (where permitted).

Australia's experience provides some insight into the relative importance of these alternative modes. The financial services sector contributes around 11 per cent of national GDP, but recorded international trade in financial services was, at the end of 2011, less than 1 per cent of total trade in goods and services. The Asian component is quite small when compared with the overall importance of Asia in Australia's trade.

But the Balance of Payment statistics on which these figures are based only capture the first three modes of financial services trade. It is the fourth mode, offshore establishment, which is the dominant mode of supply. For Australia direct sales of financial services by their foreign affiliates is around twenty times the measured exports of financial services to foreign residents.

However, in considering trade in financial services, it is important to recognise that there is a potentially important supply chain/production process element involved. Even provision of basic financial products such as loans or deposits involve a range of activities – from marketing, customer relations, processing, account management etc, which modern technology is increasingly making separable – such that some parts of the process can be undertaken at geographically separate locations. National authorities need to identify which parts of the production process are best encouraged.

Also important are technological developments which increasingly make it possible to supply financial services from distant locations – such as via purchase of insurance or financial advice over the internet.

It is also important to ask which types of financial services are the most appropriate target: retail banking; wholesale banking including trade finance; capital market development; payments services (including remittances); insurance; funds management etc.

3. Necessary Conditions

An important factor influencing the success of financial liberalisation and benefits from foreign entry of financial institutions is the quality of the “financial infrastructure”. This also impacts the willingness of foreign entities to engage in trade in financial services and the modes and types of services which are developed. The financial infrastructure can be described as the strength of:

- Strong Corporate Governance Standards and Practices
- Effective Legal Protection and Enforcement of Property Rights
- Enforcement of Reliable Accounting and Auditing Standards
- Appropriate Information Disclosure Requirements and Practices
- Strong and Effective Supervisory Agencies

A number of empirical studies have traced links between the quality of such “infrastructure” and financial sector stability, economic growth etc.

While effecting significant changes in these conditions may be politically and socially difficult, improving the financial infrastructure will bring benefits of its own accord and is necessary if the maximum benefits of increased foreign participation are to be achieved.

4. The Benefits of Foreign Financial Institution Participation

The common arguments for encouraging foreign institution involvement are that it can lead to:

- Increased competition
- Knowledge transfer
- Specialised skill provision
- Financial market deepening and improved price signals and liquidity
- Improved access to international capital
- Greater financial stability due to access of foreign financial institutions to parent funding
- Financial innovation
- Improved financial regulation and supervision

This is illustrated in the case of foreign bank entry by the following quote. “Proponents of foreign banks claim that these banks can achieve better economies of scale and risk diversification than domestic banks, and that they introduce more advanced technology (especially risk management), import better supervision and regulation, and increase competition. Because they are backed by their parent banks, foreign affiliates of international banks may also be perceived as safer than private domestic banks, especially in times of economic difficulty. Last but not least, foreign banks may be less susceptible to political pressure and less inclined to lend to connected parties.” Detragriache et al (2008, p2123)

But there are a number of recent empirical studies examining such claims, which have mixed results, but which identify the means by which benefits (and costs) arise.

Giannetti and Ongena (2009) find, from analysis of Eastern European experience that “young firms benefit most from foreign bank presence, while businesses connected to domestic banks or to the government suffer. Overall, our findings suggest that foreign banks can help to mitigate connected-lending problems and to improve capital allocation”.

It might be anticipated that the differential approaches to lending of foreign and domestic banks might have most effect on SME’s. Beck et al (2010) suggest that “arms length” lending processes relying on data and modelling may simply reflect a different loan technology without having such adverse consequences. They examine this by surveying large banks from a broad sample of countries. While they find no evidence of effects in developed countries, the results for developing countries indicate that the "share of SME lending for investment purposes is significantly lower in developing countries, while fees and interest rates are higher." However, "[t]hese differences in SME financing between banks in developed and developing countries seem to be explained by differences in the economic, legal, and institutional environment banks operate in".

Michalski and Or (2010) conjecture "that banking integration between two regions leads to higher trade flows between them. In our stylized model, this happens because banks with presence in the two regions are better able to assess risks and charge the appropriate premiums for trade-related projects pertinent for the two markets" and test this by examining interstate trade effects of banking deregulation in the USA. They find significant effects and suggest that their results "are probably lower bound estimates for financial barriers in international trade, given that the international financial system is much less integrated than the U.S. financial system"

Malinova (2008b) finds that "[f]inancial development… allows countries to expand aggregate exports, broaden their export product scope, enter more foreign markets, and reduce product churning. These effects are magnified in financially vulnerable industries."

Degatriache et al (2008) consider the impact of foreign bank entry and argue that foreign banks will be less skilled than domestic banks at assessing "soft" information about borrowers, and rely more on "hard" (eg accounting) data. They predict, and find supporting evidence, that foreign banks will have less risky loan portfolios and that in less developed countries with larger foreign bank shares there will be "shallower" credit markets. This is potentially an offset to the benefits found in a number of other studies, such as by Jeon et al (2011) of an increase in competition due to foreign bank entry.

Jeon et al (2011) find that "an increase in foreign bank penetration enhances competition in these host countries' banking sectors. We find that this positive foreign bank penetration and banking competition link is associated with a spillover effect [induced efficiency improvements] from foreign banks to their domestic counterparts. This spillover effect becomes stronger when more efficient and less risky foreign banks enter into less concentrated host country markets. We also find that the spillover effect is greater when foreign banks enter in the form of 'de novo penetration' than through mergers or acquisitions of domestic banks"

Claessens and Van Horen (2012) "find a negative relation between private credit and foreign bank presence, but only in countries with relatively distant foreign banks. Furthermore, leading up to the crisis, private credit grew faster when foreign bank presence was large, but not in countries with relatively distant foreign banks. In addition, foreign banks reduced credit more compared to domestic banks during the global crisis in countries where they have a small role in financial intermediation, but not so when they were dominant or funded through local deposits."

5. Impediments to Foreign Involvement

There are a range of reasons for government hesitance to an increased role for foreign financial sector institutions

- Prudential concerns – foreign entities and local supervision; potential taxpayer exposures from deposit insurance etc
- Local vested (financial sector) interests influencing the political and regulatory agenda
- Protectionist tendencies
- Concerns regarding exploitation or "cherry picking" by foreign entrants
- Concerns regarding the impact on credit allocation
- Concerns regarding financial stability

Stern (2010) notes that "[p]olicy reforms that free up the cross-border supply of financial services and market entry for foreign financial services providers are likely eventually to require loosening of restrictions on at least some forms of capital flows. This interrelationship often raises fears about the impact of increased competition, loss of autonomy, and the potential increased volatility of capital flows."

Aizenman and Noy (2009) measure "de facto financial openness" as the sum of total capital inflows and outflows (FDI and portfolio and other investment) as a percent of gross domestic product and find that it is affected, *inter alia,* by economic and political economy considerations but that "in an era of rapidly growing trade integration, countries cannot choose financial openness independently of their degree of openness to trade".

6. Local Approaches to Trade in Financial Services

Hapsari and MacLaren (2012) find "that the openness index measuring the level of liberalization in financial services sector through the ASEAN Framework Agreement on Services (AFAS) and the General Agreement on Trade in Services (GATS) is significant in affecting the rate of economic growth amongst five member countries of ASEAN. However, it has not been possible to isolate the effects of AFAS from those GATS because there has been little difference in the commitments contained in each of them."

Borchert et al (2012) develop Services Trade Restrictive Indexes (STRIs) for a range of services and across countries. In general financial services score lower (ie have less restrictions) than professional services and transportation, fractionally lower than telecoms, but higher than retailing. For South

Asia and East Asia and Pacific, restrictiveness for financial services is significantly above that for OECD countries. In general, worldwide, "cross-border trade in reinsurance and banking services is much more open than cross-border trade in life and automobile insurance services. Within the banking sector, offering deposit-taking services across borders is in general more restricted than borrowing from abroad." They also note that "most of Asia's emerging and large economies restrict commercial presence of foreign financial institutions in a variety of ways, including explicit restrictions on ownership, control and legal form, discretionary licensing, and limits on operational freedom."

Their econometric results indicate that "the presence of services trade policies that discriminate against foreign suppliers is associated with a lower level of investment inflows" and that "closing the banking sector to foreign providers or otherwise limiting competition through the license process appears to be linked to less access to credit by domestic entities."

Gopolan and Rajan (2010) examine liberalization policies towards foreign bank entry between 1998 and 2008 in China, India, Indonesia, Korea, Malaysia, Thailand and the Philippines, and ask "to what extent have these regulatory changes translated into actual tangible or de facto changes?" They classify Indonesia, Korea, Thailand and the Philippines as "enthusiastic liberalisers and China, India, and Malaysia as "cautious liberalisers". Paradoxically, the number of foreign banks had generally fallen, but that tended to reflect mergers. Looking at shares of total assets and total deposits, there appears to be more of an increase in foreign bank asset share, than of deposits (and in many cases that had declined). They note that "[o]verall while foreign banks have made some inroads into emerging Asia, especially Indonesia, Korea and Thailand, the extent of penetration of foreign banks in Asia as a whole has been relatively low compared to that of Central or Eastern European and Latin American countries."

7. Policy Options

It is worth noting that the particular policy approach may differ quite substantially depending on whether the objective is to develop as a regional financial sector (such as Singapore, Hong Kong, Shanghai, Tokyo, Sydney etc) or primarily to develop the domestic financial sector. Trade in financial services with regional financial centres is more likely to be focused upon intra-industry and wholesale market activities rather than provision of retail financial services, reflecting the linkage with physical trade of goods for which financing is required.

- Entry (establishment) requirements. In many countries, entry of foreign institutions is restricted in some way. One is whether entry can be by way of a branch or must be by way of a separately capitalized subsidiary. Or, activities allowed to a foreign branch might be restricted – such as no dealings with retail customers.

- Sales of financial products across national boundaries run into difficulties associated with product regulation in different markets. Harmonizing regulatory requirements, or recognizing equivalence, and permitting cross border sale of financial products can overcome this – as has happened with the Australia-NZ agreement for securities sales.
- More ambitious has been the nature of a "funds management passport" which would enable fund managers to market a particular product in a number of economies without seeking separate regulatory approval in each.
- Withholding taxes can play a negative role – inhibiting foreign investors from investing in local financial products
- Local preference arrangements can also create restrictions – indeed many pointed to the particular subsidies given by governments of some major countries to their local financial institutions as being of this form.
- Takeover and/or local ownership requirement restrictions can also inhibit foreign involvement.
- Information provision – one such development has been the creation of a *Financial Services Gateway* (www.austrade.gov.au/Gateway/) to provide better information for foreign financial institutions seeking to provide financial services to the Australian market.
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8. Measuring success

Whatever policies are adopted, it is important to have in place metrics by which the success of such policies can be evaluated. In practice, this is rarely done, except using relatively basic indicators. An increasingly rigorous range of assessment measures looks like:

- Scoring against a "checklist" of the "good/best practice" standards and codes of multinational agencies. Deviation from the standards may provide useful information, but meeting the standards is, given their quite general nature, consistent with a wide range of outcomes on performance.
- Assessment by informed observers as to whether improved has occurred, such as by survey data about perceptions of improvement against particular indicators.
- Tracking of key variables (eg asset share of foreign banks) which may indicate the effects of specific policies, although separating the effects of policy from other underlying

economic forces is problematic. Analysis of such indicators has been facilitated by the development of cross-country databases such as those at the World Bank.

- Developing specific indicators of progress towards particular objectives. Financial reform policies should identify the expected beneficial consequences of those policies and involve specification of indicators of success which are tracked, reported, and analyzed. Although such indicators will always be imperfect, and outcomes confounded by a range of unpredictable economic factors, the discipline imposed on policy makers and accountability for policy reform implied appears warranted. There is considerable scope for improvement in this regard in most economies.
- Empirical research studies which assess the effects of policy changes. Effective financial reform should result in identifiable changes in various financial market relationships which provide the opportunity to test the effectiveness (and gain guidance for future policy) of policy changes.

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