Impact of Liberalising Financial Services

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This brief reviews the evidence for the impact of liberalising markets for financial services. It begins by showing the increasing economic importance of services in general to all countries and highlighting their role in economic development. Barriers to market access occur in a number of ways and the process of liberalising financial services needs to address these along with a number of related policy issues. The impact of liberalisation is seen in:

- Stronger growth.
- Greater efficiency and financial depth.
- Support for business.
- Improved access to capital.
- The introduction of international standards.

GROWING IMPORTANCE OF SERVICES TO DEVELOPING COUNTRIES

Service industries are making an increasing contribution to the economies of developing countries. This is feeding through into a rising share of commercial exports globally:

Services' share of GDP is rising Service industries represent an increasingly important component of the economy in developing economies. As a share of national output, services between 1990 and 1999 rose most rapidly amongst middle income economies from 47% to 54%, and also from 40% to 44% in low income economies (Chart 1). Over the long term services' share of GDP in many emerging markets is likely to converge gradually on the 64% in high income economies.

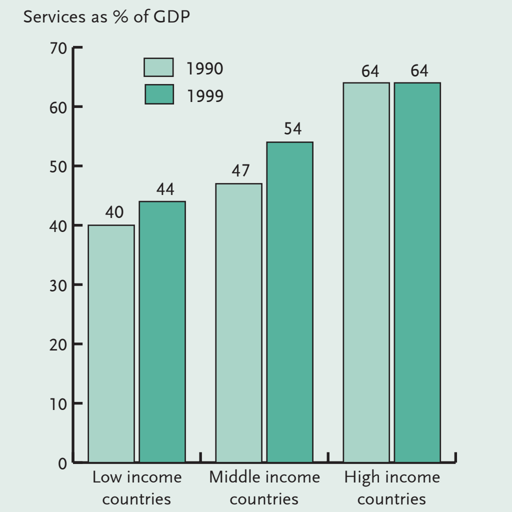
Developing countries gaining larger share of commercial service exports The greater prominence of services in developing economies is mirrored by their rising share of commercial service exports worldwide, which include financial and business services, travel and transport. Middle income countries accounted for 16.6% of all commercial services exports in 1999, up from 12.6% in 1990 (Chart 2). Low income countries share increased slightly from 1.9% to 2.1%. The total value of commercial service exports from low and middle income countries combined, more than doubled from $111bn to $237bn over this period.

SERVICES' ROLE IN ECONOMIC DEVELOPMENT

The delivery of efficient services has a crucial role to play in economic development. Each sector provides considerable scope for knowledge generation, improved quality and greater product variety. However, the growth generating characteristics of each sector makes a unique contribution to growth and economic development:

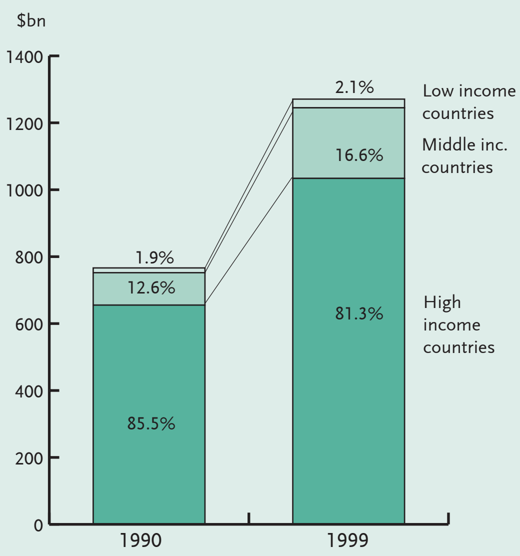
Financial services An efficient and well regulated financial sector leads to an efficient transformation of savings into investment, ensuring that

Chart 1 Services share of GDP



Source: World Development Indicators

Chart 2 Commercial service exports



Source: World Bank

resources are deployed towards those activities that yield the highest returns. Benefits are also generated from increased product variety and improved management of risk.

Telecommunications As a vital intermediate input, improved efficiency in telecommunications contributes to a more efficient supply chain for business and delivery of higher quality goods and services to the consumer. The growth of the internet has provided an added spur to the contribution of telecommunications particularly with regard to the development of e-commerce in the business to business context.

Transport services Efficient transport services facilitate the efficient distribution of goods within a country, and are particularly important in influencing a country's ability to participate in international trade.

Business services Accounting and legal services can help to reduce transaction costs, facilitate commercial transactions and set an appropriate framework for dispute resolution. They also serve to underpin a more robust regulatory environment. High accounting standards will raise the quality of reporting, improve the transparency of companies and reduce the opportunity for fraud.

Software development The development of many industries is linked to the development of suitable software.

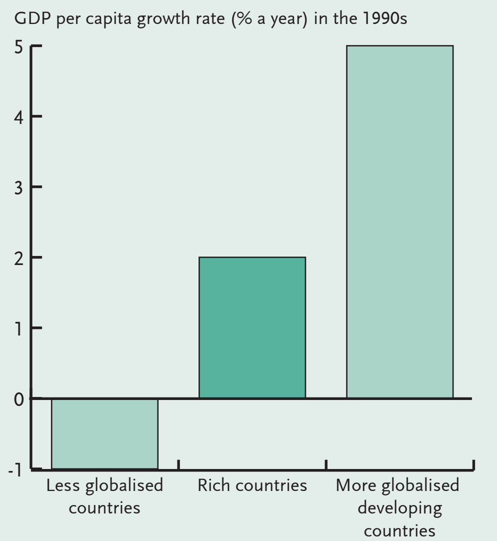
WHAT IS THE BROAD IMPACT OF MOVES TO LIBERALISATION?

Moves towards globalisation since the early 1980s have been spurred by technical advances in transport and communications technologies and by the choice of larger developing countries to improve their investment climates and open up to foreign trade and investment. During the 1990s a considerable gap opened up between these countries that have become more globalised and those that are less open to liberalisation. According to a World Bank report[1] more globalised developing countries generated growth averaging 5% a year against -1% a year for less globalised countries and 2% a year in high income countries (Chart 3).

The impact of liberalisation for the more globalised countries in general is seen in higher growth rates, reduced poverty, less dependence on primary products and more on exports of goods and services. One of the most striking examples of export growth in a developing country is the Indian software industry. India's software exports increased more that tenfold from $225m in 1993 to $2.65bn in 1999.

Moves towards liberalisation benefit firms, employees and consumers alike. Firms that are competitive and export capable are better able to compete for business in overseas markets. Employees generally enjoy higher pay and better working conditions than other firms in the local economy. Consumers enjoy the results of price and quality competition, with greater choice of products and services that are delivered to a higher quality at less expense.

Chart 3 Divergent growth rates in developing countries



Source: Dollar & Kraay, World Bank

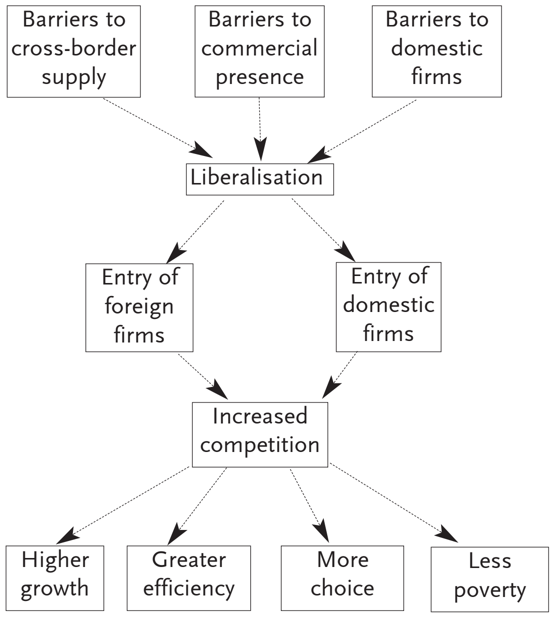
WHERE DO BARRIERS TO TRADE IN SERVICES OCCUR?

Service industries face a number of obstacles to trade that stem in part from the different ways in which services industries are accessed. Market access can be impeded by barriers in the following areas:

- ***Cross border supply of trade in services*** is conducted in much the same manner as trade in goods, with the service produced in one country and supplied cross-border to a consumer in another country.

- ***Commercial presence*** For some services, such as transport and telephone services, production and consumption of the service occur at the same time so companies need to move to the location of the consumer.

- ***Domestic competition*** Barriers may be constructed against new domestic suppliers as well as foreign companies.



Because of the larger number of channels to market access that liberalisation has the potential to open up, services have the potential to provide an impetus to growth over and above that which could be provided though liberalisation of trade in goods.

The liberalisation of financial services has considerable potential to generate growth and improve services to business and the consumer. The findings of various studies that have investigated and reviewed financial liberalisation are set out in the next section.

THE PROCESS OF LIBERALISING FINANCIAL SERVICES

The process of liberalisation involves the removal of obstacles to market access in three distinct areas:

Domestic financial liberalisation allows market forces to work by eliminating controls on lending and deposit rates and on credit allocation and, more generally, by reducing the role of the state in the domestic financial system.

Capital account liberalisation removes controls on both the movement of capital in and out of a country and also the restrictions on the convertibility of the currency.

Internationalisation of financial services eliminates discrimination in the treatment of foreign and domestic financial service providers, and removes barriers to the cross-border provision of financial services.

It is important that liberalisation is undertaken as part of a broad policy that is carefully managed and sequenced and not only takes account of these three aspects but also other related policy issues as well:

- *Supervision and regulation* While internationalisation has been shown to be a crucial factor in economic development, experience shows that it is vital to strengthen the supporting institutional framework, particularly the supervisory and regulatory functions of the state.

- *Quality of financial system* The reduction of controls on international capital movements can lead to lower costs of capital, but the speed and extent of capital account liberalisation should be determined by the quality of the financial system. Otherwise resulting inflows or outflows of capital can result in financial distress.

- *Monetary policy* Foreign firms entering a market may introduce new financial instruments, resulting in more movement of capital and funds across borders,. The conduct of monetary policy and indeed the extent of liberalisation need to be reviewed in the light of the actual or potential impact on the behaviour of money demand.

The impact of internationalisation therefore depends on how it is phased in with the other two types of financial liberalisation and the institutional framework. A World Bank simulation[2] of the liberalisation of financial services, that was based on conservative assumptions predicted that developing countries would benefit from income gain to GNP of close to $300bn by 2015, equivalent to an extra 2% of GDP. This is based on a joint reform involving competition being opened up, costs and prices lowered and market barriers removed.

The liberalisation of trade in financial services may be initiated in a number of ways through:

- Negotiations taking place under the General Agreement on Trade in Services (GATS) at the WTO.

- As a membership requirement of a regional trading arrangement such as the North Atlantic Free Trading Area (NAFTA) or the EU.

- Individual countries initiating their own reform process. This happened en bloc in central and Eastern Europe in the early 1990s .

THE IMPACT OF LIBERALISING FINANCIAL SERVICES

Measurement of the impact of liberalising financial services internationally has been the subject of recent studies. The key findings show that liberalisation can have a positive impact:

1. Generates growth *Liberalisation of financial services has generated stronger economic growth, particularly in developing economies* A study by Mattoo etc.[3] that constructed a measure of openness for financial services and telecommunications in 60 countries indicated that those countries that fully liberalised their financial and telecom sectors tended to have GNP growth up to 1.5% a year faster in the 1990s. The impact of liberalisation was strongest for the 37 developing countries in the sample, suggesting that services liberalisation could bring greater growth benefits to developing countries.

The financial services index was based on two indicators. The first was the commitments of individual countries under the GATS, used as a measure of national openness to competition and foreign ownership; while the second was a capital controls index to show the openness of each country's current and capital account.

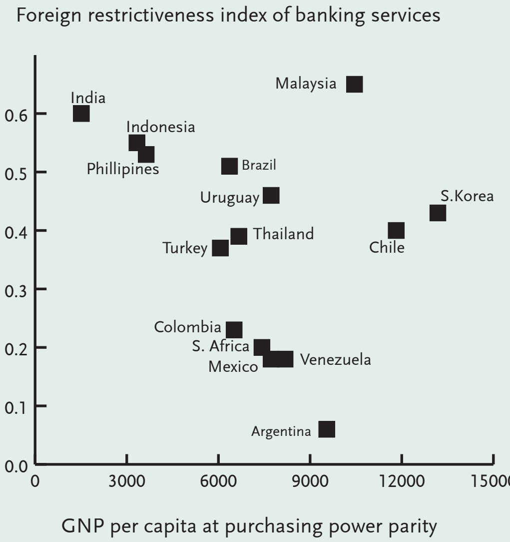
Less restricted banking sectors are found in countries with higher GNP per capita This study by McGuire and Schuele[4] constructed an index of foreign restrictiveness of 23 middle and high income economies and the EU as a whole. The model showed that countries with a less restricted banking service sector tended to have higher GNP per capita than those countries where banking was more restricted. The middle income countries are featured in Chart 4.

The index incorporates restrictions on commercial presence covering licensing of banks, direct investment, joint venture arrangements, and permanent movement of people. Measures of restrictions on the raising and lending of funds by banks, on the types of business undertaken, and on the number of outlets were also included in the index.

The development of stock markets and banks help to influence economic growth This study of 40 countries for the 1976-98 period by Beck and Levine[5] emphasised the positive role financial development of domestic markets has played in economic growth. Both banks and stock markets each independently contribute to growth.

2. Promotes efficiency *Banks' interest rate spreads are higher in countries with restrictions on foreign banks* Foreign trade restrictiveness was found by Kalirajan etc.[6] to be a significant determinant of the interest rate spread for banks in 27 economies. Foreign trade restrictions protect domestic banks from foreign competition. The lack of competition allows domestic banks to charge higher prices for their services and operate less efficiently, reflected in

Chart 4 Relationship between GNP and foreign restrictions on banking services



Source: Mcguire & Schuele

interest spreads that were 5-60% higher than they would have been in the absence of trade restrictions (Chart 5).

The price impact measures were highest, at over 45%, for Indonesia, Malaysia and the Philippines, which have very tight entry controls and prohibit new foreign bank licences. In Chile, Singapore, South Korea and Thailand the restrictions had a price impact of between 30-40%. Interest rate volatility also was found to have an impact on spreads but market structure was not found to be a determinant.

Presence of foreign banks is greater where the domestic banking sector is less efficient Focarelli and Pozollo[7] undertook a study of the locational choices of 143 banks with at least one shareholding abroad across 28 countries (yielding 4000 location decisions in total). They found that foreign presence was greater where local banks have higher average costs, lower net interest margins, less charge-offs and higher cash flows, signalling an inefficient use of capital.

3. Promotes financial depth *Liberalisation contributes to domestic financial depth in the medium term* A study by the IMF[8] of 50 developing countries indicated a positive long-term correlation between financial depth and capital account openness. Annual stock market turnover was equivalent to 8% of GDP in open economies and only 3% in closed economies. The annual value of credit advanced to the private sector totalled 35% of GDP in open economies and only 27% in closed (Chart 6). A country was defined as open when its openness measure exceeded the average for all countries for the entire period under review, 1970-99.

4. Supports business *Foreign banks provide support to local business large and small* Clarke etc.[9] undertook an analysis of foreign banks lending to businesses in Argentina, Chile, Colombia and Peru in the late 1990s. Although the study found that foreign banks lent less to SMEs than domestic banks it found that the this distinction was far less pronounced for the larger domestic and foreign banks with which the comparison is more appropriate. Indeed the gap was closing, as the growth rate of foreign bank lending to SMEs was higher than for large domestic banks in three of the four countries.

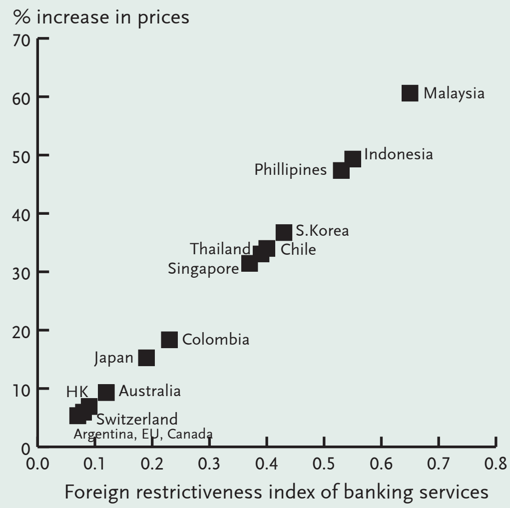
5. Enhances financial systems As well as contributing to the various factors cited above, the presence of foreign financial institutions can also help in building more robust and efficient financial systems by:

- Gaining access to modern financial services that facilitate the development of a competitive export sector.

- Improving access to foreign capital and international capital markets.

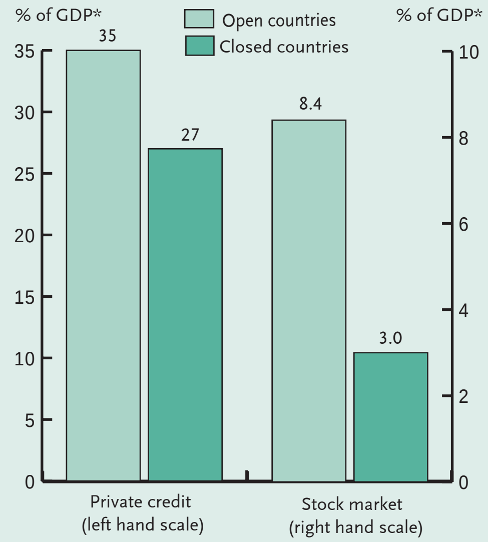
- Introducing international standards and practice, with foreign financial service companies likely to be supervised on a consolidated basis with the parent by supervisory authorities that are more familiar with the types of activities undertaken by large financial organisations.

Chart 5 Impact on interest rate spreads of foreign restrictions on banking services



Source: Kalirajan, McGuire, Nguyen-Hong & Schuele

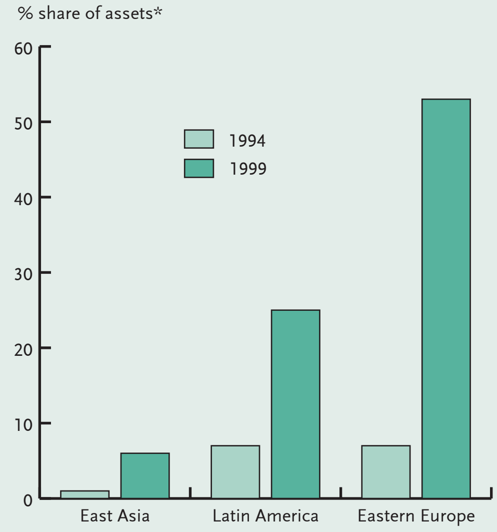
Chart 6 Impact of liberalisation on financial development



*1970-99
Source: IMF

The period since the mid-1990s has witnessed a sharp increase in foreign bank presence in many emerging markets, particularly in central Europe and Latin America (Chart 7). According to IMF estimates[10], between 1994 and 1999, foreign bank control of assets rose from 3% to 53% in central Europe and from 8% to 25% in Latin America. This has been prompted by the desire of the authorities to improve the efficiency and stability of their financial systems and to help reduce the costs of restructuring and recapitalising troubled banks. In Eastern Europe, privatisation has contributed to the substantial increase in foreign control, following a number of domestic banking crises in the first half of the decade. In Latin America leading Spanish financial institutions have played a key role in acquiring 30 banks in 10 countries. Foreign control, at about 18%, remains much less in the biggest markets of Brazil and Mexico, than many other countries in Latin America.

Chart 7 Foreign banks' share of assets



*Ratio of assets where foreign banks own more than 50% of total equity to total bank assets

Source: IMF estimates

Foreign banks have brought in new technologies, improved risk management systems and new products to these markets. Competitive pressures on local banks have increased and there have been improvements in banking sector efficiency, indicated in lower operating costs and narrower margins.

Similar evidence of falling margins and improvement of services has historically also been found in countries acceding to the EU, notably Spain, Greece, Ireland and Portugal. Although market share has risen to around a half in some central European and Latin American countries, overall, it is the presence of a number of foreign banks rather than their market share that is the key influence in reducing overheads and eliminating unduly high levels of profitability.

Some commentators have argued that foreign banks are more likely to exit a country in the face of an economic or financial crisis. However, during a crisis, it is the overall financial health of a bank, domestic or foreign, that is the key factor in its ability to sustain its operations. Moreover, the strength of a foreign bank's commitment to a country will be reinforced if it is able to operate through a local branch or subsidiary. The presence of a foreign bank may also help to stabilise the domestic financial system and deposit base of a country in a time of crisis through a flight to quality. All the other positive influences that foreign banks bring, connected with greater growth and efficiency, fostering of financial depth and access to capital while being subject to a strong supervisory framework, may also contribute to enhanced stability.

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This IFSL brief has been compiled by Duncan McKenzie.

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