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Financial services: Global perspectives

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Abstract

The purpose of this paper is to discuss the issues related to the deregulation of the financial services sector and the role of multilateral negotiations which has opened up opportunities for the expansion of international financial services. The paper analyses various categories of international financial services and highlights those factors that contribute to an increase in the competitiveness of financial institutions in their attempt to increase the supply of international financial services. The paper also analyses the complementary role of FDI and trade in international financial services and discusses some of the benefits of FDI in financial services that have led to a more efficient and more competitive financial services industry in the host countries.

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1. Introduction

The Uruguay Round of trade negotiations has provided opportunities for many financial institutions to expand their business activities globally. Over the last two decades there has been a significant effort made to quantify the amount of international financial services provided and improve and enhance the way these international data are entered into national statistics. A number of research studies explored the role of financial development, an effective financial services sector and deregulation of financial markets as those factors that have contributed to economic growth and to global financial market integration. For instance, the study by Beck and Levine (2002) finds that economic growth is linked to overall financial

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development and the financial services industry. The study by Demirguc-Kunt and Maksimovic (1998) indicates that a firm's growth is positively related to the development of both the securities market and the banking system. The study by La Porta et al. (2002) demonstrates that free market and private ownership of banks are more conducive to economic growth than those countries whose banks are mainly owned by the government. Furthermore, there has been a new way of defining and categorizing the international activities of financial institutions and the way their activities may contribute to an increase in the volume of trade in financial services. As national financial markets have gradually become deregulated, more and more financial institutions have expanded their direct foreign investment (FDI) in the host countries. The increase in FDI activities led some researchers to analyse and measure the contribution of FDI in financial services on the host countries' financial markets. The increasingly integrated global economy, greater competition and deregulated financial markets have also contributed to the consolidation of financial institutions and have increased their ability to be create more financial innovations and also to offer product differentiation in financial services.

The purpose of this paper is to analyse some of the key issues that are relevant to the increasingly globally integrated financial services industry and highlight some of the developments that have assisted both the policy makers and researchers to understand some of the issues that are pertinent to further development of the international financial services better. To this end, Section 2 deals with trade negotiations on financial services, Section 3 deals with the definition of trade in financial services, Section 4 discusses the typology of international financial services, Section 5 discusses how international financial services can be explained in the context of the theories of comparative advantage; Section 6 deals with the role of FDI in promoting international financial services and assisting the development of the host countries' financial services sector; Section 7 concludes.

2. International financial services and the role of GATS

The Uruguay Round of trade negotiations has paved the way for the deregulation of financial services in many developing and developed countries and has led to a significant increase in the volume of international financial services activities. It is noteworthy that further negotiations on trade in financial services continued, after the completion of the Uruguay Round, with a new Agreement reached under the General Agreement on Trade in Services (GATS) in December 1997. The Agreement covers many facets of the financial service sector including insurance, securities companies as well as the banking sector. Under the GATS, the US and the EU are committed to allowing their markets to be opened to all foreign banks and insurance companies. Furthermore, Japan is also committed to further liberalization in the banking and insurance industry. There are also a significant number of developing countries which are also allowing for gradual deregulation of both their banking and insurance sectors. All these commitments and deregulations are leading to a greater increase in the international financial services products and the emergence

of more consolidated financial institutions at the global level. As the WTO in various publications indicated, the declaration of the Fourth Ministerial Conference in Doha in November 2001 also provided a mandate for the implementation of the Uruguay Round of Trade negotiations. The WTO General Agreement on Trade in Services (GATS) requires all members to continue negotiations in order to progressively liberalize trade in services, including financial services. The first round of these negotiations started in early 2000 and is expected to be completed in 2005. The Doha Declaration not only endorsed such negotiations but also supports a speedy and limited time for the conclusion of these negotiations.

GATS obligations encompass both general trade as well as some specific commitments by individual members. As is stated by the WTO, one of the most important obligations is transparency. This obligation requires all members to publish “all relevant measures of general application” that influence trade in financial or other services. The second obligation is the Most-Favoured-Nations (MFN) principle which is designed to stop any member from discriminating against other members. Market access (Article XVI) and national treatment (Article XVII) are two more principles incorporated into the GATS. However, these two principles are subject to national treatments of these two principles, and being incorporated into the national rules. Indeed, the commitment of the members to GATS would still allow the Member countries to pursue national regulatory policies and macroeconomic policies in order to achieve some domestic objectives, if need be.

In the area of banking, again various reports from the WTO indicate that the majority of developing countries made commitments on the acceptance of all types of lending and deposits. The countries in Eastern Europe are the most committed members in this regard, followed by the Latin American countries. Similarly, in the insurance sector, the Eastern European as well as the Latin American countries have been in the forefront of commitment, although countries that embrace the elements of trade liberalization in insurance cover 95% of the GDPs of all continents. In the case of banking this percentage is, on average, 97%.

3. Trade in financial services

While in the past, national statistics used to register fees and commissions of financial institutions as trade in financial services predominantly, this definition was broadened due to the increasingly integrated financial markets and changes in the role of the financial institutions. International financial services now cover three distinct elements of the current account balance of payments of countries. These three categories, listed below, are well articulated in the work of the OECD (1989) and Moshirian (1994a):

- (1) Income from direct investment, received and paid. This category includes all the incomes of multinational financial institutions including the insurance and banking companies which have FDI in the host countries.

- (2) Income from the other (financial) investments received and paid. This item includes all the investment activities of individuals and financial institutions that have international investment activities in bonds, equities and banking and insurance markets. This item encompasses banks' foreign assets and their international lending activities.
- (3) Commissions and/or fees received and paid. This item, which used to be a small part of the financial institutions income, has increased significantly. The OECD (2002) indicates that for the major banks in the US, Germany and France the proportion of this item with respect to the total income of these banks has increased from 30, 23 and 15 to 48, 47 and 68 over the period 1982–1999, respectively. However, at the present time, the OECD data do not break the non-interest income of the major banks into domestic and international incomes.

Data provided by the IMF in the Balance of Payments Yearbook indicate that the US, Switzerland and the UK are the largest exporters of trade in financial services. Furthermore, according to the data provided in the annual report of the BIS (2003), Germany had the largest share of banks' international assets whereas Japan's supremacy in this area in the 1990s has diminished, though it remains number two, ahead of the US and the UK. Similarly, the data from the BIS (2003) show that the UK, the US, Japan, Germany and Switzerland remain the major financial centres in providing the necessary financial services to multinational financial institutions.

4. Typology of international financial services

GATS has accepted four types of trade in financial services. These categories have been articulated by Moshirian (1994b). While in the past, national statistics did not adequately collect the appropriate data for trade in financial services (see Arndt, 1984; Moshirian, 1993), data collection for international financial services improved in the 1990s and hence a large majority of the following four international financial services activities are captured in the national statistics of the OECD countries:

4.1. No movement of providers or receivers

This category of international financial services is similar to trade in goods and hence any international transaction between two financial institutions (or one financial institution and one individual) from two distinct countries, without having a physical presence in each other's country, could fall into this category. (In the case of two financial institutions, for them to qualify as part of this category, one would assume that these two institutions have different nationalities, both of them are not incorporated, and the transactions are taking place in only one of these two countries.)

4.2. *Movement of providers only*

This category refers to Foreign Direct Investment (FDI) by multinational banks, insurance or securities firms or similar companies that attempt to establish their branches in the host countries. Indeed, the significance of FDI and the importance of direct access to the host countries' markets have led to the rapid growth of FDI in financial services to the extent that FDI in financial services is as important, if not more important, than international trade in financial services. Due to trade liberalization in financial services since the Uruguay Round of Trade Negotiations, FDI in financial services has significantly increased over the last few years. This in turn has opened a new debate on the role of multinational financial institutions in the development and efficiency of financial services in the host countries. To this end, the next section of this paper will deal with this specific issue. In the meantime, one should distinguish between those Multinational Companies (MNCs) that are locally incorporated in the host countries and those that are not. This distinction is important, as the former are treated like domestic companies and hence their incomes generated in the host countries are not treated as an export of financial services from the source country to the host countries. However, these locally incorporated MNCs incomes are recorded in the current account balance of the host countries as "direct investment income flows" (i.e., the third category defined above). Given the nature of financial products and the importance of close proximity to the clients, FDI in financial services has been one of the major sources of the increase in the volume of international financial services.

4.3. *Movement of receivers*

This category refers to the activities of financial institutions which provide services to individuals and companies that physically go to the foreign countries or offshore centres in order to become the recipients of financial services. The services provided to these clients will be recorded as the export of financial services from the country in which these institutions are situated (provided that they are locally incorporated in that country).

4.4. *Movement of providers and receivers*

In this category, financial services are provided by a foreign financial institution that is not locally incorporated in the host country to a foreign customer (a company or an individual) who is not either resident or locally incorporated in that host country. An example of this case could be a Japanese company operating in the US which is not locally incorporated, borrowing funds from an unincorporated British Bank situated in the US. In this case, the financial services of the British Bank in the US will be recorded as a UK export to Japan.

5. Comparative advantage in financial services

The modern trade theories have been used to test for the existence of factor intensity and factor endowment envisaged in the Heckscher–Ohlin–Samuelson (H–O–S) theory as well as other new factors that have been identified in the 1960s and 1970s as the major sources of comparative advantage in goods. The same empirical testing has been conducted in the area of financial services by Moshirian (1994a) who used the modern trade theories including factor intensity, factor endowment and technology in testing the comparative advantage of financial institutions within the OECD countries. Human resources, physical capital, economies of scale and R&D are considered as the significant factors in providing a comparative advantage for financial institutions in the OECD countries over the developing countries. These factors may well explain the reason for the dominance of multinational financial institutions amongst some of the leading OECD countries which are the main players in the global financial services industry. At the same time, there has been an increase in trade in financial services within the OECD countries due to close business relationships and interactions between financial institutions which are able to provide differentiated financial products to both financial institutions and individuals within these countries. The increase in trade in product differentiation in financial services is well captured in the Intra-Industry Trade (IIT) theory developed mainly by Grubel and Lloyd (1975). For international financial services, IIT occurs when a country simultaneously exports and imports financial services generated by the financial institutions. It is different from inter-industry trade in which a country could specialize in financial services and exports it in exchange for a different good or service for which it has no comparative advantage. Li et al. (2003) have shown that there is a considerable amount of IIT in insurance services generated when the US financial institutions deal with foreign financial institutions.

6. The role of FDI in international financial services

The earlier studies of trade in goods such as Caves (1981) and Balassa and Bauwens (1987) demonstrated that FDI is a substitute for trade and hence these two activities should be treated as substitutes for each other. However, as multinational corporations have become the main players in the global economy, Helpman (1984) and Helpman and Krugman (1985) developed a trade theory in the presence of IIT in which FDI was an integral part of generating more international trade. They placed an emphasis on the role of FDI and intra-firm trade in contributing to the volume of international trade. However, the positive contribution of FDI and trade was not empirically tested in the 1980s and the studies by Caves (1981) and Balassa and Bauwens (1987) have not taken into account the above theoretical development by Helpman and Krugman. In the meantime, Markusen and Venables (1998, 2000) built on the trade model of Helpman and Krugman and argued that there should be a positive relationship between FDI and trade. In other words, in the case of international financial services, an increase in FDI by the multinational

financial institutions will add to an increase in the volume of trade in financial services. The recent study by Li et al. (2003) has demonstrated a positive relationship between the volume of trade and FDI in insurance services which confirms the importance of market access and establishment of multinational financial institutions in the host countries as a way of increasing international financial services. This may well explain the simultaneous increase in both the volume of trade and FDI in financial services in recent years. Furthermore, as the second category of trade in financial services is “movement of providers only”, one can see the dynamic effects of physical presence of multinational financial institutions on the expansion of international financial services.

The previous studies of foreign banks activities in the host countries did not use the most appropriate proxy to measure the determinants of those factors contributing to the expansion of FDI in banking services. However, the recent study by Moshirian (2001) has demonstrated that neither the number of offices owned by US banks nor the assets of US banks’ foreign branches fully reflects the amount of US FDI in banking services. This study paved the way for accurate measurement of those factors that contribute to the expansion of FDI in banking services. There have been some criticisms of the foreign banks in the host countries such the recent work by Clarke et al. (2003) who also highlights a number of positive contributions of foreign banks in the host countries. Furthermore, there have also been a number of other studies that indicate a significant positive contribution made by foreign banks in the host countries. For instance, according to Claessens and Huizinga (2001), FDI in banking has increased the overall efficiency of domestic banks. Similarly, Beck and Levine (2002) argued that the presence of foreign banks improve the efficiency of the domestic banking system and hence the interest rate appears to be lower where foreign banks have had a presence. The recent study by Gelos and Rodos (2002) also indicates that due to the increasing influence of foreign banks in the host countries, the level of concentration measured by Hirshman–Herfindahl (HH) indices did not increase as much as it could otherwise have done, in different parts of the world.

7. Conclusion

The purpose of this paper has been to analyse and discuss some of the issues that are relevant to the global financial services industry. To this end, the issues related to trade negotiations in financial services have been highlighted. The four categories of financial institutions’ activities that generate trade and FDI in financial services have been analysed. The paper has argued that the increase in financial innovations and product differentiation in financial services has led to the emergence of IIT in financial services amongst the leading financial institutions. Due to the consolidation of the financial institutions and the deregulation of financial services, one would expect to see more competition, an increase in financial products innovations and growing product differentiation in financial services which in turn would contribute to an increase in consumer welfare. The recent models of trade in the presence of IIT

supports the positive contribution of FDI in expanding the volume of international financial services. This result indicates that the increase in deregulation and permission given to financial institutions to establish their branches in the host countries are amongst those factors that enhance the efficiency of the host countries' financial services industry which in turn could contribute to sustained and steady economic growth which have been experienced in the emerging markets.

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