Revised
7.15.02

Liberalization of Global Financial Services

Stanley Fischer[1]
Vice Chairman, Citigroup Inc.

Institute for International Economics
Washington, DC, June 5, 2002

The title of this conference, *Further Liberalization of Global Financial Services Markets?*, ends with a question mark. There are at least three questions. First, would further liberalization of financial services be good for the liberalizing countries and their citizens? Second, if further liberalization is desirable, where are the priority areas? And third, will financial services in fact be further liberalized as part of the Doha process, and perhaps also other negotiations?

I will address the first two questions.

It seems natural to start with the broader issue of capital account liberalization, which has been a preoccupation of academic and policy economists and many in the official sector for many years. But capital account liberalization and opening of the domestic financial sector to foreign entry, while related, are not identical issues. A country may permit foreign firms to compete in the domestic financial sector even while restricting capital flows; certainly Citigroup has operated in many countries that substantially restrict capital flows. It is also possible that a country may permit a wide range of capital flows but seek to protect the domestic financial sector by excluding foreign firms. Nonetheless, it is likely that financial sector and capital account liberalization are in practice positively correlated – that countries that open the capital account are more likely also to liberalize the financial sector by permitting more foreign competition in the provision of financial services.

The provision of some financial services demands access to international markets, and thus cannot take place unless the corresponding capital flows are permitted. If, for instance, firms are not allowed to borrow or issue equity abroad, one set of global financial services is ruled out. But countries can both maintain some control and allow firms access to global markets, by requiring permission for such transactions on a case-by-case basis.

[1] I am grateful to Stephanie Flanders for assistance, and to my Citigroup colleagues, Jeff Shafer, Lew Alexander, Michael Andrews, Ari Barkan, Michael Froman, Lionel Johnson, and Kim Schoenholtz for helpful discussions.

In brief, although capital account liberalization and financial services liberalization are related topics, they are not identical. I will therefore start by briefly summarizing my views – which are I think essentially the consensus view – on capital account liberalization, and then turn to financial services liberalization.

I. Basic Principles for the Opening of the Capital Account

Opinions on capital account opening have gone through a familiar cycle in recent years. There was considerable distrust of liberalization and support for capital controls in the 1970s and 1980s. In the 1990s capital market opening was more fashionable, as emerging markets began to seek out large amounts of international finance. Indeed, in 1997, the British proposed that the Articles of Agreement of the Fund be amended to include the promotion of international capital flows as one of its purposes. Following the Asian crisis, that initiative disappeared from the international agenda, and it is safe to say that today distrust of capital account liberalization is more in vogue.

My own view is that in the course of their development all countries will want to liberalize the capital account and fully integrate with global capital markets. This is based on the fact that all the advanced economies have very open capital accounts. And it is based on what I believe to be the correct reading of the existing economic evidence: which is that the economic benefits of a well-sequenced orderly opening of the capital account on balance outweigh the costs.[2]

However, countries should approach capital account liberalization with great care. We have been reminded in recent years that overly rapid liberalization of the capital account – especially at the short end – holds risks for any country, and enormous risks when macroeconomic stability, the domestic financial system, and domestic financial regulation are not yet strong enough. In addition, countries need good data to be able to monitor inflows and outflows. All of which is to say that countries need to calibrate their access to international capital to the capacity of their domestic economies systems safely to absorb it.

Like many, I think this implies that countries should liberalize long term investment first, and should have few restrictions on foreign direct investment. At the short end, some form of Chilean-style controls on inflows may be a useful prudential measure until a country's macro-economic policy and financial system are sufficiently strong.

[2] A few years ago, in 1997, in discussing the proposal that orderly capital account liberalization should become a formal goal of the IMF, I argued that the evidence on the growth effects of capital account liberalization was then at the same stage as the evidence on current account liberalization had been in the late 1980s – pointing in a particular direction, but very weak. In the period since 1997, the evidence that capital account liberalization is good for growth has on balance strengthened, though it is not as yet conclusive. This was clear, for instance, at a World Bank conference on the topic, *Financial Globalization: A Blessing or a Curse?*, held May 30-31, 2002. The papers are available on the conference website.

However, these broad comments do not do justice to the many complex questions that arise when it comes to the proper pacing of capital account liberalization, the impact of different capital restrictions, and the do's and don'ts of prudential management. These are questions to which the economics profession and the international system do not yet have a clear set of answers, and on which there is considerable need for more research. If the IMF's articles of agreement were amended to include the promotion of *orderly* capital account liberalization, as proposed in 1997, the Fund and the profession would be more likely to develop a more rigorous body of knowledge for countries to use in thinking about these issues. It is a pity that such an amendment is no longer on the agenda.

Clearly, that particular battle is not going to be won any time soon. But what is interesting to note is that you can be on either side of the capital account liberalization debate and still think it makes sense for countries to allow foreign providers to participate in the domestic market for financial services. Rightly or wrongly, countries could choose to adopt some capital restrictions to protect themselves against large-scale capital movements, and still embrace substantial liberalization of domestic financial services. This would be particularly true if foreign direct investment and long-term capital inflows were broadly permitted, albeit with some remaining controls. Many of these restrictions would also be consistent with the kind of access that Citigroup and other US financial service providers are looking for in the Doha negotiations.

II. The Economic Case for Liberalization of Global Financial Services

George Stigler used to argue that you need only one good reason to do something. There is one good economic reason for a country to allow foreign firms to participate in the home financial market – competition. In observing different financial systems around the world, I have seen nothing to suggest that banks and other financial service providers should be protected from the effects of competition. Quite the contrary. Just as in other parts of the economy, more competition holds the promise of more efficiency and more innovation – and a better deal for both producers and consumers in captive domestic markets.

These are real benefits when one considers that weak and inefficient domestic financial systems constrain long-term growth in many emerging market economies.[3] Experience in many developing countries – not to mention Tokyo, London and New York – suggests that the entry of sophisticated foreign providers can do much to accelerate the development of the financial sector. They do this partly through offering more efficient and more varied services to domestic savers and consumers, but also through the more efficient technology they introduce to the economy. Directly and indirectly, participation of foreign providers holds the promise of a large-scale transfer of skills and expertise – on everything from credit quality control to worker training.

[3] While it would be desirable to quantify the growth impact of strengthening the financial system, I am not aware of quantitative work on the magnitude of this impact, aside from the growth regressions that show that financial depth (measured for example by the ratio of M2/GDP) is positively associated with growth.

Citigroup provides a good example of the transfer of skills. It offers financial services training to its own employees, and sometimes to other trainees, in many developing countries. In my short time in the firm, I have been impressed by how often it turns out that a member of top management of a local financial firm has previously worked for Citgroup. And the number of former Citigroup employees who have become high government officials is legend – almost as many as the number of MIT economics department graduates.

There is the question of whether sophisticated foreign entrants may overwhelm weak supervisory systems that are used to dealing with relatively less sophisticated domestic firms. That is conceivable. But the right response is not to keep out foreign competition for some extended length of time – but rather, to strengthen the supervisory system, which should be done in any case. And there is a great deal of international technical assistance available to help countries do this.

I believe we have now dealt with the first question, whether further financial sector liberalization would be good for the liberalizing countries and their residents. The answer is yes. I take it for granted that further financial sector liberalization would be good for the global suppliers of financial services such as Citigroup. So the next question is what are the priority areas for effective liberalization of financial services.

III. Core Principles of an Effective Agreement

From the standpoint of Citigroup and other leading US providers, there are four basic issues:

First, the right of establishment as either a branch or a wholly owned subsidiary.

For competition to work, foreign providers need to be able to set the terms of their participation on the basis of market conditions, not arbitrary ownership limits. Joint ventures in banking have a checkered history, even in well-developed markets such as London, where there was a string of failed joint ventures in the early 1970s.

Regardless of the precise terms, a firm that is forced to team up with a domestic provider is being asked to put both its balance-sheet and its global reputation behind an enterprise that it cannot fully control. If things go badly, it will tend to pay more than its fair share of the costs. Once the global brand is attached to the project, it matters little whether the share is 80% or 20% -- the foreign bank will still have to bail out failing operations or else risk serious damage to its global reputation. Effective participation requires effective control or it is simply not worthwhile.

Second, national treatment

Foreign financial service providers ought to be treated the same as local firms, and be able to offer the same products in different parts of the country as local firms. More than in most sectors, it is important to have a level – and unrestricted – playing field if the benefits of effective competition are going to be realized. In Singapore, for example, foreign banks cannot participate in local ATM networks – a basic pre-requisite for competing effectively in local consumer markets.

Third, no hidden market barriers

Even with the right to establish and national treatment, foreign firms can still find themselves effectively barred from participating as equals in the domestic market, for example through limits on the number of domestic licenses that essentially lock in the status quo.

Non-transparent relationships between domestically owned providers and local financial regulators are a common problem. In many countries, establishing transparent and non-discriminatory domestic regulations and administrative procedures for all financial institutions – domestic or foreign – will be essential if the right of establishment is to be more than a piece of paper. More important, such regulations and procedures are good for the efficiency of the entire domestic financial system.

Fourth, the reduction of barriers to cross-border data flows

This sounds like a very technical issue, but some countries do prevent cross-border transmission of financial data. This may, for instance, prevent the use of a processing center in another country, which is a common practice and source of banking sector efficiency. There are also sometimes restrictions on the cross-border transmission into a country of data reporting on corporate results within the country. And there are concerns that some of the restrictions on cross-border data flows proposed by the EU in the interests of protecting privacy may seriously constrain the ability of foreign firms to analyze the behavior of debtors, and refine risk categories and categorization.

In this context let me say how pleased I am that the United States and the European Commission have resumed discussions, so that data flows between these important markets will not be in jeopardy. Vigorous, open and transparent competition among our financial services firms will surely be essential to the continued expansion of the global economy.

These are the four main issues, of which the first three – the right of establishment, national treatment and reduction of hidden barriers – are the most important. But of course they are not new issues. They have featured prominently in bilateral and multilateral negotiations on this subject for years, and were high on the US agenda in the last WTO round.[4]

As a result of the 1997 WTO agreement, foreign providers' right to majority-owned local operations in all OECD countries and many emerging market economies was more or less set in stone. And the existing rights of foreign providers were assured in markets accounting for the overwhelming majority of global trade in financial services.

[4] They are also identified as the key issues in Wendy Dobson and Pierre Jacquet, *Financial Services Liberalization in the WTO*, Washington, DC: Institute for International Economics, June 1988.

In that sense, the agreement was an important first step toward a global market in financial services, because many countries that had begun down the liberalization road promised not to step back. But clearly, it left a great deal more to do.

Changes in regulatory systems in developed and emerging market economies since 1997 have generally but not all been in the right direction. And unfortunately they have sometimes been at odds with the goals of market access and national treatment. Especially in Asia, progress on further opening to foreign providers has been slim, despite the evident need for financial sector reforms following the Asian crisis. Further liberalization in this region will be a major priority for the US financial sector in any future negotiations.

From the standpoint of the US financial sector, there are some well-known drawbacks to the WTO as a forum for resolving these issues, not least, the tendency to see the development of financial markets as one chip in a very large poker game. That view is particularly unsuited to issues of financial regulation and market development. And of course, the US does not have the same leverage in financial services negotiations today that it did before 1997, when the relevant MFN exemption was still in place.

Does this mean that the new round of WTO negotiations is a lost cause? Well, that's the third question, which I didn't plan to discuss. In any case, I don't think so. But it does mean that we should not let it be the only game in town. Finance ministers and central bankers need to continue to make the economic and financial case for liberalization in their bilateral and regional contacts with countries. And the Administration needs to make sure the issues of financial market development and regulatory transparency are high on the agenda at APEC and other regional meetings. They should also be on the table in FTA negotiations with Chile and Singapore, as well as on the agenda of FTAA negotiations, if and when these get started. In the struggle to win hearts and minds for more open and competitive markets, history tells us that that the more government involvement, the better.

IV. Concluding Remarks

Let me conclude where I began. Countries should be very careful in liberalizing their capital account and certainly they should not do so at the short end without effective regulatory regimes and strong macro-economic policies. But that is very different from saying they should keep their doors shut to foreign financial service firms. I do not think any of the elements I have highlighted would involve forcing countries to liberalize or deregulate their financial systems in a way that would jeopardize their economic stability.

In light of recent experience there are conflicting views on whether the presence of foreign financial firms makes the domestic financial market more stable or resilient to crises. However difficult the current situation in the Argentine banking system, I think that system is better off with significant foreign participation than it would have been without it. Others may see it differently. But few would argue that foreign participation has made things worse. More generally, it does not seem very plausible to me that granting US companies the opportunity to sell life, health and auto insurance, as well as banking services in a country somehow undermines its national financial stability.

I saw the economic and financial consequences of weak and protected financial systems again and again while I was at the IMF. I felt then that opening the financial services market to foreign providers would be an effective way to spur much-needed improvements. That is why I believe that further liberalization of trade in financial services should be pursued – and pursued vigorously. Thank you.