

FINANCIAL OPENING IN ASIAN COUNTRIES – PROGRESS AND ISSUES

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I. INTRODUCTION

- Financial service is a major component of the General Agreement on Trade in Services (GATS)
- GATS covers virtually all of the world trade in financial services.
- 4 different Modes of financial services trade identified by GATS
Cross-border (Mode 1); Consumption abroad (Mode 2); Commercial presence (Mode 3); Presence of natural persons (Mode 4)

- Financial opening has enormous policy implications for macroeconomic and financial stability, economic growth and financial development.
- Prudent, orderly opening is crucial.

<Relations between two different liberalizations: Financial Services and Capital Account>

- Confusion arises in that people do not distinguish between cross-border capital flows and int'l flows of financial services (“financial opening”).
- The second does not necessarily always entail the first. (e.g., Provision of financial advice /information)
- In most cases, however, services transactions involve cross-border capital flows. (e.g., banking) ⁵

Comparison of Domestic Deregulation (DD), Capital Account Liberalization (CAL), and Financial Services Liberalization (FSL)

(Example)

(Credit)	<u>Domestic funds</u>	<u>Int'l Funds</u>
<u>Domestic Supplier</u>	DD	CAL
<u>Foreign Resident Supplier</u>	DD, FSL	CAL, FSL
<u>Overseas Supplier</u>	FSL	CAL, FSL

* GATS requires the liberalization of capital flows that is essential for/ related to financial services provided by foreign suppliers.

* However, a coherent linkage between the two different liberalizations exists.

- Any heavy capital control will discourage entry of foreign financial institutions.

II. OVERVIEW OF FINANCIAL OPENING IN ASIA

- *Countries to be covered: Indonesia, Korea, Malaysia, Singapore and Thailand*
 - *all crisis-affected countries*
 - *high exposure to the global economy/finance*

<Indonesia>

- Banking (a) Branch offices only in 10 cities in principle; (b) Foreign-Indonesian joint ownership with existing banks, not allowed for a new license (GATS).
- Equity holding (a) Local existing bank 49% of the listed shares; (b) Non-bank finance company 100%; (c) Others 49%
- Securities brokers must establish a local company to run the business.
- Presence of natural persons (a) Expatriate directors, managers, experts advisors for 3 years and extendable; (b) Manager or technical expert requires two Indonesian understudies
- Cross-border supply and consumption abroad.prohibited generally.

<Korea>

- Banking In 1998 after the crisis, most restrictions were removed to increase commercial presence.
- Equity holding (a) 100% for any financial institution; (b) 100% for stock investments in private companies; (c) Bond markets are fully open.
- Presence of natural persons Allowed. Korean banks can recruit foreign nationals as directors (May 1998)
- Cross-border supply and consumption abroad are partially allowed for banking and investment advisory.

<Malaysia>

- Banking (a) The 13 wholly foreign owned are permitted to remain at the same status; (b) New licenses are not allowed.
- Equity holding (a) Entry of foreign banks is limited to equity participation in local commercial/merchant banks; (b) aggregate foreign shareholding in a bank and a securities company not more than 30%.
- Presence of natural persons Not allowed except for temporary presence of senior managers and specialists in relation to commercial presence.
- Cross-border supply and consumption abroad. Prohibited generally. Offshore financial institutions allowed in Labuan.

<Singapore>

- Banking (a) One office only, and off-premise ATMs and new sub-branches not allowed.
- Equity holding (a) Bank 40%; (b) Insurance company 49%; (c) Securities company unbound
- Presence of natural persons Intra-corporate transfers of managers, executives, and specialists for a three year period. Extendable for two additional years.
- Cross-border supply and consumption abroad. unbound generally, except for insurance.

<Thailand>

- Banking (a) Commercial presence generally no restrictions for existing foreign bank branches.
- Equity holding (a) Foreign equity participation up to 49% in principle; (b) the following only 25% - life and non-life insurance companies, local incorporated banks, and securities companies.
- Presence of natural persons Unbound except a corporate transfer of the managerial or executive level or a specialist for a one-year period. Extendable but altogether for not more than three years.
- Cross-border supply and consumption abroad unbound generally. Foreigners not allowed to purchase or own land,

III. IMPACT OF FOREIGN ENTRY – Case of Banking

- Foreign banks' asset share in the banking sector remained low in Indonesia and Korea prior to the crisis (6-10 %)
→ *too low to be a critical contributor to the crisis.*
- After the crisis, the share in all three countries rose. (The largest rise is seen in Indonesia and Korea)
→ *A counter-cyclical lending behavior*

Market Share of Foreign Banks (%)

	INO (Incl joint banks)	KOR (Foreign only)	MAL (Foreign only)
1996	9.4	5.5	22.2
1997	12.8	8.0	22.5
1998	13.7	5.9	22 (est)
1999	22.2	5.4	22.6
2000	27.7	Above 6.4	24.2
2001 (Nov)	24.7	Above 6.5	24.9

Market penetration is most significant in Korea.

- Since the crisis, foreign banks have increasingly relied on domestic source of operating funds.

Source of Operating Funds of Foreign Banks, Korea, %

	<u>Domestic</u>	<u>Foreign</u>	<u>Total</u>
1995	23.5	76.5	100.0
1996	18.6	81.4	100.0
1997	21.1	78.9	100.0
1998	37.4	62.6	100.0
2000	62.3	37.7	100.0
2001(Nov)	68.0	32.0	100.0

Issue 1: Financial Opening and Crisis

A. Advantages and risks of financial opening (Advantages)

facilitate economies of scale, increasing competition, increasing managerial efficiency, and reduce price markups

(Reservations) The most noteworthy is “the opening is often accompanied by capital account liberalization and banking and financial crises in most cases are associated with capital account liberalization or wrong sequences of liberalization measures.”

B. Causes of the Asian Crisis

The root cause of the crisis is the serious mismanagement of huge overseas borrowing by *domestic* (not foreign) banks.

- related to the imprudent capital account liberalization in early 1990s.

* Foreign banks have kept a stable and counter cyclical lending behavior.

Issue 2: Post-crisis policy: Korean and ASEAN approaches

- Korea : more active opening in the post-crisis
- ASEAN remained conservative after the crisis.
- → deserves a careful study on two different approaches.

IV. POLICY SUGGESTIONS

Financial services liberalization is a big challenge to the four ASEAN countries.

- Their opening has been relatively limited (even under ASEAN Framework Agreement on Services, AFAS)
- Consider their extensive exposure to foreign trade and global economy.

(A) Three Guiding Principles

Financial opening must

- increase *resource mobilization*
- not disturb *financial stability*
- promote *market competition*

(B). Suggested Liberalization Strategy

1. Sequencing of financial opening

- Possible areas for further opening are banking, leasing, guarantee activities, long-term investments in debt markets, int'l underwriting of local bonds, and FDI in local banks.

(Merits of banking sector opening: stable foreign capital, foreign investment, and globalized services)

- Singapore needs a different strategy: develop the offshore market as an int'l financial center.

2. “Commercial presence” first

- followed by “Cross-border” supplies.
- The latter involves free movements of services, capital and information (e.g., int’l hedge funds) without sufficient supervisory mechanisms in place.
- The second also does not strictly satisfy the three guiding principles.

3. Implementation of sound capital account liberalization policies in parallel

- Opening of financial services is closely associated with capital account liberalization.
- Delay capital account liberalization till an effective regulatory and supervisory framework and appropriate macro regime are in place.

4. Gradual opening of domestic equity markets

5. Keeping a broad picture of a target portfolio at the national level is desirable.

(Short-term vs long-term)

(Bank loans, equities and bonds, and foreign direct investment)

- taking into account the magnitude of foreign capital in need, envisaged productivity of different capital components, and their volatility.